CHAPTER 2

Issuance, Amendment, and Duration

A. Underlying Agreement

Letters of credit are used to satisfy underlying obligations. LC issuance is usually preceded by an agreement between the intended applicant and beneficiary that obligates the applicant to the beneficiary and that also provides for the issuance of a letter of credit to support the underlying obligation.

Typically, the intended LC beneficiary is a seller or lender to whom the applicant is or is about to become obligated. Occasionally, the applicant is not the obligor in the transaction underlying the credit and is merely accommodating the obligor. Parent corporations, for example, frequently apply for bank letters of credit to be issued in favor of those doing business with the parent’s subsidiaries.

The underlying obligation to be supported by an LC is typically specified in a written sale, loan, or other agreement made before the LC is issued. Sometimes the underlying obligation is based on an oral agreement or on an anticipated agreement that is made after the supporting LC is issued. Sometimes the underlying obligation is based on a regulation
requiring delivery of cash collateral, an insurance company bond, or a bank letter of credit.

1. Effect of Underlying Agreement on Letter of Credit: The Independence Principle

Although every letter of credit supports an underlying obligation, the terms and even the existence of the underlying obligation need not be proven in order to enforce the credit. Leaving aside the defense of fraudulent drawing, LC issuance and performance by an issuer are independent of the underlying transaction. § 5-103(d). The independence principle applicable to an issuer's obligations distinguishes letters of credit from suretyship undertakings and is the single most important feature of letter of credit law and practice.

2. Effect of Letter of Credit on Underlying Agreement

Although the LC independence principle severely limits the effects of the underlying transaction on the beneficiary's rights and the issuer's liabilities under the LC, the reverse is not true: the underlying obligation is affected by LC issuance and by drawings under the LC. The extent of those effects depends on the law governing the underlying obligation, not LC law.

Occasionally an LC or an LC amendment is the only writing that indicates the intentions of the parties to the underlying agreement on payment, delivery, and other terms. If so, the law governing the underlying transaction determines whether and what significance the LC or LC amendment has on the underlying transaction, including whether the letter of credit may serve to satisfy a statute of frauds applicable to the underlying transaction.

The underlying obligation and the law governing it determine whether issuance of a letter of credit satisfies the under-
lying obligation or merely suspends it while the credit remains outstanding. A "letter of credit" term in an underlying agreement for the sale of goods is generally understood to refer to a letter of credit which, when issued, does not discharge the seller's obligation to pay, but does suspend that obligation until payment is effected under the credit. The understanding that the seller will draw under the LC rather than demand direct payment from the buyer might be reversed if the underlying agreement described the LC as a "standby" or as an LC requiring presentation of a document indicating applicant default.

The underlying obligation and the law governing it also determine whether and how the beneficiary is to apply LC proceeds against the underlying obligation. In practice, the applicant and beneficiary typically intend that the underlying obligation will be satisfied automatically to the extent that the credit is honored. On the other hand, they rarely, if ever, intend that the underlying obligation will be satisfied by mere issuance of a letter of credit. If a letter of credit is dishonored, the beneficiary normally has the rights and remedies based on the underlying obligation as well as the LC obligation.

Article 5 does not govern the effects on the underlying obligation of LC issuance, amendment, presentation, honor, or dishonor. The emphasis in LC law and practice is on LC independence from the underlying transaction. Accordingly, LC issuance (and application for LC issuance) should be preceded by an applicant-beneficiary agreement that sufficiently provides for the underlying obligation, the type of LC required to support that obligation, the continuation or suspension of that obligation after LC issuance, and an accounting to the applicant for any LC proceeds received by the beneficiary. The underlying agreement should also provide for the effects of the applicant's failure to obtain a letter of credit in the form required by the underlying agreement, because that failure should be actionable as a breach of the underlying agreement.
under the law applicable to that agreement but not under LC law.

B. Application

After the parties to the underlying transaction agree that one party's obligations are to be supported by a letter of credit, that party applies to the intended issuer for issuance of the agreed credit. Typically, the applicant completes a form of application provided by the intended issuer on which the applicant requests issuance of the LC and specifies its terms. The form, in addition, often allocates the risks of issuance between the applicant and the issuer and provides for the issuer's compensation, reimbursement, and indemnification, as well as for security and other matters that would be covered in any credit agreement.

1. Proposed Credit

The typical bank form of application for a commercial credit requires the applicant to complete a checklist which includes the essential terms of the invoice, transport document, and other documents that will evidence performance of the underlying sale agreement by the beneficiary-seller. Applications for standby credits commonly require the applicant to specify the entire text of the beneficiary statement or other document that is to be presented under the LC. In either case, issuers review the form and content of the requested credit, even if a creditworthy customer assumes all risks of issuance, because issuers wish to comply with all applicable laws and to protect their own reputations for issuing credits that are clear and complete.

Sometimes the beneficiary, or a governmental agency that regulates the beneficiary, dictates the form of the credit. In these cases, the applicant and issuer need only decide whether
to proceed and, if so, whether the LC form imposed on them raises any peculiar risks to be specifically addressed or reallocated as between themselves.

2. Proposed Allocation of Risks

Issuers review each completed application and any applicable continuing agreement with the applicant to make sure that the applicant agrees to compensate the issuer for LC issuance, to indemnify the issuer against claims and liabilities arising out of LC issuance, and to reimburse the issuer upon LC honor. Article 5 expresses an issuer's basic right to immediate reimbursement, excludes issuer responsibility for the acts of others, and limits an issuer's responsibility to performance of its LC undertakings under standard practice. § 5-108. Many banks, however, require clearer or greater protection against loss arising out of LC issuance, and some applicants will insist on special protection. For example, either or both parties may wish to clarify that the UCP or other LC practice rules are incorporated into the credit, the issuer-applicant agreement, or both.

3. Variation of Statutory Reimbursement Obligations

Article 5 allows parties almost complete freedom to vary its effects, with the proviso in § 5-103(c) that a general disclaimer is not sufficient to vary Article 5 obligations. Accordingly, if an issuer is to be authorized to honor documents that only "substantially" comply or to examine only the demand for payment, then an explicit agreement or disclaimer may be required to vary the effect of the issuer's § 5-108 obligations to an applicant to honor only those presentations that strictly comply. For this purpose, a general disclaimer of liability for acts taken in good faith may prove insufficient.
4. Issuer Acceptance

An issuer of a letter of credit is concerned primarily with its ability to obtain reimbursement for any payments it makes under the credit. Accordingly, the decision to issue is typically based on the strength of the issuer's legal rights against the applicant, the applicant's creditworthiness, and the issuer's familiarity with the applicant. The issuer typically does not know the beneficiary, has no contractual rights against the beneficiary, and has only limited rights against the beneficiary as a presenter of documents to the issuer. Thus, the identity of the beneficiary is generally irrelevant to the issuer's decision to issue a letter of credit.

An issuer that pays under a commercial letter of credit upon presentation of a negotiable bill of lading should have a lien against that document and, therefore, should be able to realize on that document and the goods covered by that document if the applicant fails to reimburse the issuer. Because of the transaction costs involved in exercising control over the goods and arranging for their disposition, however, the issuer's lien on the documents it receives from the beneficiary is usually of uncertain value and therefore of secondary importance to an issuer.

As a general matter, banks are under no obligation to issue LCs upon the request of their customers. Bank LC application forms frequently do not provide for the issuer to commit to issue a credit or even to sign the application. Rather, they generally provide for issuer acceptance by the act of LC issuance. This is true even where the issuer and applicant have signed a master agreement covering applications that may be made and acted on in the future. The typical master agreement provides for reimbursement and other terms applicable in the event a credit is issued, but does not commit the issuer to issue any specific letter of credit.
5. Issuer Compensation

Issuers typically require applicants to agree to pay the issuer’s out-of-pocket costs plus a percentage fee based on the maximum amount available to the beneficiary. That percentage fee typically reflects the applicant’s assumption of substantially all risk, and for creditworthy applicants is therefore likely to be under one percent of the LC amount. In the case of large, long-term standby letters of credit supporting municipal bonds, percentage fees for issuers have been as low as one-tenth of one percent per annum.

C. Issuance

1. Signing

By definition, a “letter of credit” must satisfy Article 5’s formality requirements. § 5-102(a)(10). It must therefore be in writing or otherwise qualify as a “record.” Also, the issuer must sign it; alternatively, the record must be authenticated in accordance with standard practice or the parties’ agreement on authentication. § 5-104.

Occasionally, a purported LC issuer defends on the grounds that it lacked the power or right to issue the LC, that an individual signer lacked authority, or that a signature was not genuine. These kinds of defenses should be resolved by resort to the formality requirements for letters of credit codified in § 5-104, supplemented by general principles of law and equity referred to in § 5-102(c) and § 1-103.

2. Sending

A letter of credit is issued and becomes enforceable according to its terms against the issuer when the issuer sends it to the beneficiary or to another person requested to act as an adviser. § 5-106. No consideration is required to support LC issuance. § 5-105. Accordingly, LC issuance does not depend
on acceptance, reliance, or even receipt by the beneficiary. The critical requirement is that the issuer send or otherwise transmit a "letter of credit." When an LC is sent, the issuer is bound and may not revoke or amend its LC obligations unilaterally.

3. Advising

The issuer of a letter of credit may send the credit directly to the beneficiary. Because the time and risks involved in sending documents increase with distance, most cross-border commercial credits are sent by issuing banks to advising banks by electronic means under interbank agreements and systems designed to transmit, authenticate, and protect the confidentiality and integrity of interbank messages. A bank issuer normally requests a branch or correspondent bank located near or suggested by the beneficiary to act as adviser.

By definition, an adviser is one who, at the issuer’s request, notifies the beneficiary that a credit has been issued. § 5-102(a)(1). Anyone requested to be an adviser may decline to advise or, having advised, may decline to do anything else (i.e., decline to confirm, effect a transfer, or receive, examine, or give value against a presentation). Anyone who undertakes to act as an adviser must check the apparent authenticity of the request and must advise accurately, unless these statutory obligations are specifically disclaimed. § 5-107(c).

4. Labeling

A letter of credit need not be labeled as such. Conversely, merely labeling an undertaking a "letter of credit" does not make it one. The crux is whether the document sets forth a definite undertaking by the issuer to honor a documentary presentation by payment or delivery of an item of value.

"Letter of credit" is defined in § 5-102(a)(10) so as to include independent letters of guarantee, which are typically labeled "demand guarantee," not "letter of credit." These are
undertakings issued by banks throughout the world to pay on the beneficiary's first demand and without regard to the actual status of the underlying transaction.

5. **Non-Bank Issuers**

Letters of credit are not always issued by banks. In many cases the issuer is a financial institution that might be treated as a bank, broadly defined. In other cases, the issuer may be a parent corporation issuing a standby letter of credit in lieu of a guarantee to support its subsidiary's borrowings from a lender.

The Article 5 definition of "issuer" specifically excludes individuals acting for personal, family, or household purposes. § 5-102(a)(9). This consumer exclusion is intended to prevent creditors from overreaching consumers by inducing them to sign a letter of credit undertaking instead of a guarantee and thereby eradicating defenses that a consumer might otherwise have under non-LC law. It is nonvariable. § 5-103(c).

Non-bank issuers are obligated, absent disclaimer, to observe standard LC practice, even if that practice is a banking practice unfamiliar to them. § 5-108(e).

6. **Two-Party Credits**

Although most letter of credit transactions involve separate persons acting as applicant, issuer, and beneficiary, Article 5 does recognize so-called two-party credits in which the issuer issues the credit to itself or for its own account. To avoid misuse of these options, however, only financial institutions may issue two-party credits. §§ 5-102(a)(10), 5-103(c).

7. **Content**

In order to know whether a "letter of credit" has been issued, as distinguished from whether a promise or accessory guarantee has been made, one must read the undertaking, including any incorporated practice rules, in its entirety in
light of the definition of "letter of credit" in § 5-102(a)(10). There are three requirements. First, is the undertaking "definite"? Second, is it to honor a "documentary" presentation? Third, will performance of it take the form of payment or delivery of an item of value?

Bank letters of credit typically specify the name and address of the issuer and the beneficiary, the documents to be presented, the amount available, and where, when, and how presentation may be made. Bank letters of credit also typically include specific language or incorporate LC practice rules that engage the bank issuer to honor. There are no magic words to express a letter of credit undertaking. A letter of credit may say, for example:

- we agree to pay your demand . . .
- funds are available against our receipt of a statement in the form attached, completed, dated, and signed by you . . .
- this credit is available by our acceptance of your draft accompanied by the following documents . . .

Sometimes it has been so unclear whether or how an undertaking was to obligate the person signing it that courts have relieved the signer of any obligation or, at least, of the peculiar obligations of a letter of credit issuer. The "definiteness" requirement preserves this possibility.

An LC undertaking must call for a "documentary presentation." An undertaking that is payable on a given date without a documentary presentation is not a letter of credit. Most LCs specify the documents to be presented; some may rely on practice rules that provide for presentation of a written demand for payment. Undertakings that include nondocumentary conditions may be and generally are treated in the marketplace and enforced in the courts as letters of credit by applying the interpretive rule, which is recorded in LC practice rules and codified in § 5-108(g), that LC issuers must ignore nondocu-
mentary conditions if any are stated in a letter of credit. If, however, an undertaking is clearly and fundamentally conditioned on the issuer's determination of the actual facts of performance or nonperformance of the underlying transaction, then it may be denied LC status. It may instead be treated as a promise, guarantee, or surety bond to be enforced in accordance with the law applicable to such non-LC undertaking.

Bank undertakings are rarely denied LC status on this basis because LC bankers are generally able to keep nondocumentary conditions out of LCs at the point of issuance, and they ignore conditions that are clearly nondocumentary at the point of examining a presentation.

The requirement that a letter of credit must obligate the issuer to honor it by making a payment or delivering an item of value excludes undertakings to build a building or clean up a polluted site. Bank letters of credit overwhelmingly provide for the payment of funds (at sight or later pursuant to an accepted draft or a deferred payment undertaking). Accordingly, this requirement, insofar as it permits delivery of an item of value other than currency or gold, has not been tested much in practice or in the courts.

The definitions of “issuer” and “letter of credit” are among the few provisions in Article 5 that are nonvariable. These provisions dictate which undertakings do and do not qualify as “independent” and are therefore governed by letter of credit law rather than the law applicable to contracts, guarantees, and the like. §§ 5-102(a)(9) and (10), 5-103(c).

8. Incorporating Practice Rules

Most LC undertakings are expressly made subject to LC practice rules such as the UCP. Section 5-116(c) recognizes the effectiveness and primacy of incorporated practice rules. Undertakings made subject to LC practice rules are thereby made more definite and documentary and are to that extent
made more likely to qualify for letter of credit treatment under Article 5.

To the extent that there is any conflict between incorporated practice rules and Article 5's nonvariable provisions specified in § 5-103(c), Article 5 governs. There are only a few nonvariable provisions in Article 5, most of which limit the kinds of undertakings that may qualify as letters of credit and protect their independence.

D. BENEFICIARY ACCEPTANCE

Beneficiaries do not "accept" letters of credit addressed to them or any particular term or condition in them. Beneficiaries have no obligation under letters of credit, although in drawing under them they may incur liability as originators and/or transferors of the documents. A beneficiary who is unhappy with the terms of a letter of credit (e.g., identity of issuer, identity of any confirmer, choice of law, choice of UCP, expiry date, or description of goods to be shipped) has no rights against the issuer, because, apart from the LC itself, the issuer has no obligation to the beneficiary. The unhappy beneficiary must instead use its leverage in the underlying transaction with the party whose obligation is to be supported by the letter of credit. To the extent that the underlying agreement describes the LC required, a failure to provide the required LC would result in a breach of the underlying agreement. To avoid such breach the other party in the underlying transaction must arrange for an LC amendment or a new LC. If the contractually required LC is not provided, the unhappy beneficiary's rights and remedies depend solely on the underlying contract, except in the rare case in which the beneficiary has obtained the issuer's direct commitment to issue the required LC.
E. IRREVOCABILITY/AMENDMENT

Unless it provides otherwise, a letter of credit, when issued, is irrevocable. This presumption of irrevocability, which was introduced in the 1993 revision of the UCP and is codified in § 5-106(a), reflects the usual commercial understanding and purpose of letters of credit, protects parties dealing with LCs from being misled, and generally increases the acceptability of LCs in the commercial marketplace.

After LC issuance the rights and obligations of the issuer, beneficiary, applicant, and any confirmer may be affected only by an amendment to which the affected person has consented. § 5-106(b). This rule assumes that the credit does not itself provide that it may be revoked, canceled, or amended without such consent. It is not unusual, for example, for a credit to provide that it may be reduced in amount at a specified future date or that it may be terminated on 30 days prior notification.

Even though an amendment is not effective against the beneficiary until it consents, an amendment sent by the issuer may bind the issuer upon its sending. Accordingly, the issuer may be bound to honor a drawing by the beneficiary that complies with the terms of the original LC, or, if the drawing shows that the beneficiary has consented to the amendment, the terms of the amended LC.

F. DURATION

Most letters of credit state that they expire on a specific calendar date. Some are “evergreen,” in that they state that they continue or are automatically extended or renewed until, e.g., 30 days after the issuer gives notice to the contrary. For the few credits that make no provision for expiry, Article 5 presumes a duration of one year. § 5-106(c). It also mandates a five year duration for credits that purport to be perpetual. § 5-106(d).
The limitation on perpetual credits is one of the few mandatory provisions in Article 5. § 5-103(c). In this regard, perpetual credits are those that continue at the discretion of someone other than the issuer. The typical “evergreen” credit (e.g., one that may be terminated at the issuer’s discretion by sending a 30-day notice to the beneficiary) is not “perpetual.” Credits may state an expiry date more than five years after issuance. They may run longer than five years where the issuer declines to exercise its discretion to send a notice of termination, nonextension, or nonrenewal under an LC’s evergreen provision.

Letters of credit may include timing requirements other than expiration of the credit. For example, most commercial LCs require that transport documents be presented within 21 or fewer days after shipment, and some standby LCs provide for periodic automatic reductions of the amount available.