

PRESENTED AT

**49TH ANNUAL WILLIAM W. GIBSON, JR.
MORTGAGE LENDING INSTITUTE**

September 17-18, 2015, Austin, TX
November 5-6, 2015, Dallas, TX

**STANDBY LETTERS OF CREDIT
TIPS AND TRAPS**

Marilyn C. Maloney

Marilyn C. Maloney
Liskow & Lewis
Houston, Texas
mcmaloney@liskow.com
713.651.2938

TABLE OF CONTENTS

	<u>PAGE</u>
I. WHAT IS A LETTER OF CREDIT?	1
A. Not a Guaranty or Surety Bond	1
B. An Independent Agreement to Pay a Sum of Money	1
II. TYPES OF LETTERS OF CREDIT	1
A. Documentary	1
B. Standby	1
C. Differences in Function	2
III. LAWS AND CUSTOMS GOVERNING LETTERS OF CREDIT	2
A. UCC5	2
B. ISP98	2
C. UCP	2
D. UNCITRAL	2
E. Regulatory Restrictions	3
F. Supplementary Provisions	3
IV. BASICS OF A STANDBY LETTER OF CREDIT	3
A. Parties to the Transaction	3
B. Independent Nature of the Letter of Credit Transaction	4
V. ISSUES IN DRAFTING THE LETTER OF CREDIT	5
A. Documentary Conditions	5
B. Documents are Important	6
C. Irrevocability	6
D. Assignability or Transfer	7
E. Expiration of the Letter of Credit	8
F. Partial Draws	9
G. Choice of Law	9
VI. ISSUES IN PRESENTATION OF THE DRAW AND DECISION TO HONOR OR DISHONOR	9
A. Form of Documents	9
B. Original Letter of Credit?	10
C. Obligation of the Issuer to the Account Party	10
D. Obligation of the Issuer to the Beneficiary	11
E. Injunctions Against Honor of the Draw; Fraud and Forgery	13
VII. ISSUES AFTER HONOR (OR DISHONOR) OF THE LETTER OF CREDIT	13
A. Reimbursement Obligation	13
B. Subrogation Rights	14
C. Rights against the Beneficiary	14
VIII. BANKRUPTCY TREATMENT OF LETTERS OF CREDIT	15
A. Overview of Bankruptcy Concerns	15
B. A Letter of Credit is Not Property of the Bankruptcy Estate	15
C. Bankruptcy Injunction; Automatic Stay	15
D. Preferences	15
E. Special Issues for Landlords	16
IX. SECURITY INTERESTS AND LETTERS OF CREDIT	16

APPENDIX 1 Sample Form of Letter of Credit Providing Advanced Notice to the Applicant of the Intent to Withdraw

APPENDIX 2 Sample Form of a Clean Letter of Credit that Does Not Provide Advance Notice to the Applicant

RESOURCES FOR FURTHER STUDY

I. WHAT IS A LETTER OF CREDIT?

Whether your client is required to furnish a letter of credit, is requiring the issuance and delivery of a letter of credit in its favor, or is the bank that will issue the letter of credit, there are several basic principles that should be considered when negotiating the terms of the letter of credit. These will be discussed in greater detail later in these materials. At the beginning, however, it is helpful to understand the basic nature of a letter of credit.

A. Not a Guaranty or Surety Bond

While a letter of credit is neither a guaranty or a surety bond, it may perform a similar function in providing financial assurance for the payment or performance of an obligation. The essential differences between a letter of credit and a guaranty or surety bond are discussed later in these materials.

B. An Independent Agreement to Pay a Sum of Money

In its most basic form, a letter of credit is an independent agreement by the issuer to pay a sum of money to a beneficiary upon the presentation of certain specified documentation. Although there are many technical requirements that will be discussed in these materials, the basic simplicity of the letter of credit transaction makes it a useful tool in a wide range of financial and commercial settings.

II. TYPES OF LETTERS OF CREDIT

This paper will focus on standby letters of credit rather than documentary letters of credit. While the fundamental principles applicable to the two types of letters of credit are the same, their uses are different.

A. Documentary

Letters of credit facilitate commerce within and among countries. For instance, a U.S. seller may be unwilling to ship goods to a buyer in another country based solely upon the foreign buyer's agreement to pay. Not only would the seller bear the risk of non-payment, but it also might be required to enforce its rights in the foreign country. The delivery to the seller of a letter of credit as a condition to shipment shifts those risks in favor of the seller. On the other hand, a U.S. buyer of foreign goods would want assurance that goods nominally fulfilling requirements of a purchase order are shipped before it is obligated to pay for the goods. Typically, the documentary letter of credit is payable only on submission of documentation such as shipping receipts, bills of lading, invoices, freight receipts, insurance, and inspection certificates evidencing that the seller has complied with sales contract.

B. Standby

Standby letters of credit provide a source of payment of an underlying contractual obligation, such as a loan, a lease, an acquisition agreement, or other payment or performance obligation. This paper will focus on the use of standby letters of credit.

C. Differences in Function

There are differences in the function of documentary and standby letters of credit. In the documentary transaction the parties expect to draw upon the letter of credit because it is the method by which the seller is to receive payment for his goods. No default or other action by the buyer is required as a condition for the draw.

In the case of a standby letter of credit, it is typical, although not required, that the letter of credit is drawn only if there is a problem with the transaction or the account party has in some way breached an obligation. For instance, a letter of credit issued to a regulatory agency to ensure environmental remediation may be called upon if the account party defaults in the payment of its obligations. If a letter of credit backs a bond, the letter of credit may be drawn upon only if the bond is called and the bonding agency is required to pay the obligee.

III. LAWS AND CUSTOMS GOVERNING LETTERS OF CREDIT

There are several laws and customs that may govern a letter of credit.

A. UCC5

Article 5 of the Texas Business and Commerce Code as currently in effect in Texas was adopted in 1999 at § § 5.101-5.118 (hereafter “UCC5”). UCC5 does not limit its application to either documentary or standby letters of credit. When reviewing older letter of credit cases, be aware that there were substantial changes enacted in 1999.

B. ISP98

The International Chamber of Commerce has adopted International Standby Practices (“ISP98”). This was adopted in 1998 specifically to standardize practices with respect to standby letters of credit. Prior to that adoption, many issuers used UCP, discussed below, for standby as well as for documentary letters of credit.

C. UCP

The International Chamber of Commerce has adopted Uniform Customs and Practices for Documentary Credits (“UCP”). This was first published in 1933 and was subsequently revised in 1955, 1962, 1974, 1983, 1993, and 2006. The current revision, ICC Publication No. 600, was adopted in 2006. The UCP memorializes customs and practices of issuers of documentary letters of credit. However, it was widely adopted as governing standby letters of credit prior to the adoption of ISP98. While many issuers now use ISP98 for standby letters of credit, some issuers will still utilize UCP. As in the case of the adoption of revised UCC5, there were substantial changes between UCP No. 500 (and earlier versions) and the current No. 600. Discussions are beginning regarding the drafting and adoption of a UCP 700. One proposal would remove standby letters of credit from the scope of the UCP.

D. UNCITRAL

The United Nations Commission on International Trade Law adopted Conventions on Independent Guarantees and Standby Letters of Credit in 1995. This report has been adopted by the General Assembly and has been referred to the member nations who may choose to adopt its principles.

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

Title search: Standby Letters of Credit: Tips and Traps

Also available as part of the eCourse

[Commercial Lending: From Letters of Credit to Closing Protection](#)

First appeared as part of the conference materials for the
49th Annual William W. Gibson, Jr. Mortgage Lending Institute session
"Standby Letters of Credit: Tips and Traps"