

Letters of Credit - Avoiding Supply Chain Interruptions

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Letters of Credit (LOCs) have long been used to minimize the financial risk of international purchase agreements. Sellers and buyers may agree to use LOCs to ensure that goods are received and payment is remitted as intended. Essentially, LOCs function to eliminate the requirement to either pay or release goods without commercial protection by instead agreeing upon the sequence of events under which the transaction will be consummated. LOCs typically establish terms providing for the draw of monies only upon presentment of shipping documents, such as bills of lading, or other documentary evidence demonstrating presence of the goods in the country of destination. This is a valuable tool particularly where trust between the parties is low, although we are often called upon to provide counsel for resolving supply chain interruptions when LOC transactions do not proceed smoothly.

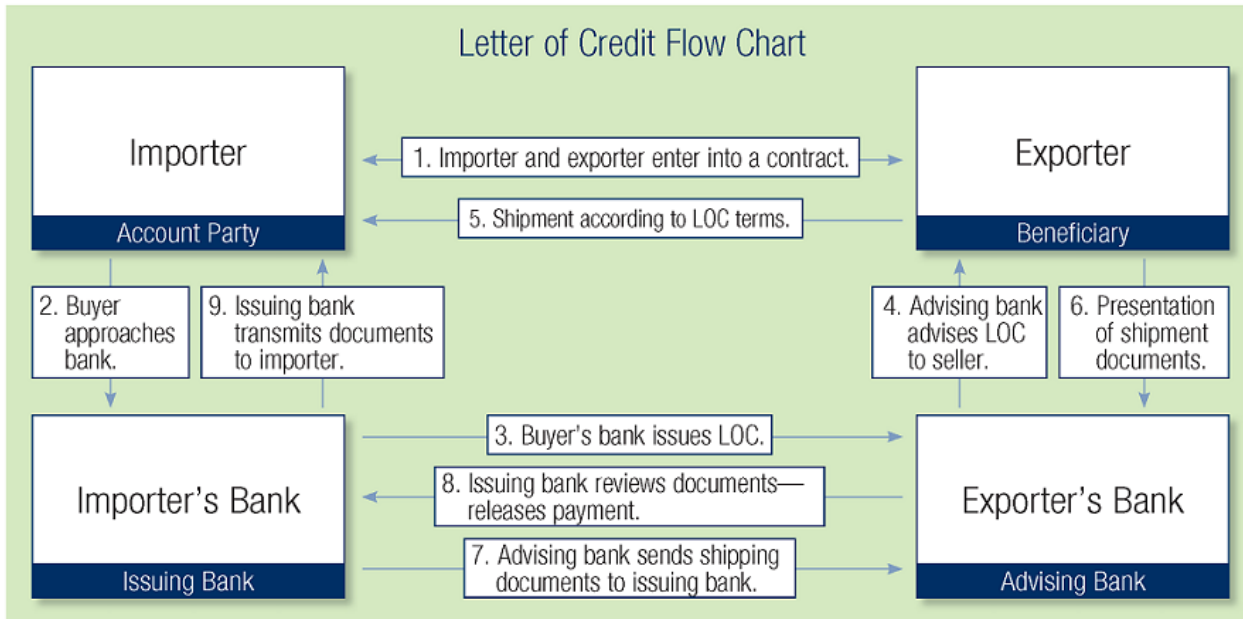
LOCs as Tools for International Trade

A buyer wishing to import goods begins the LOC process by requesting that its bank issue the LOC (the Issuing Bank) to the seller (the Beneficiary) and the seller's bank (the Confirming Bank) in support of a purchase agreement. The LOC is itself an agreement that the Issuing Bank will "honor drafts or demands for payment on compliance with the conditions set forth in the letter of credit."^[1] If a seller, or more commonly the seller's documentation, complies with the LOC terms and conditions, then the Issuing Bank is obligated to release the monies designated by the LOC. Thus, the specific conditions of an LOC are key to managing commercial risk in the international transaction.

Commercial LOCs typically involve one of two types of payment terms-either a date draft or a sight draft. A date draft sets forth a date on which the payment is to be made, which is most often the date the buyer has received the goods purchased.^[2] A sight draft, on the other hand, requires presentment of the LOC and other documentation before payment is made. In either form, the date or sight draft serves as the principal mechanism for payment between buyer and seller. The terms and conditions of the LOC must therefore be strictly observed or the transaction itself will not be consummated. This is in contrast to standby LOCs, which are also used to minimize risk in international trade but serve only as a guarantee in the event of buyer default.

Presentment of an original bill of lading is often an element of an LOC's terms and conditions. Those terms will specifically require a particular origin, destination, description of goods, sailing dates and other relevant information about the shipment. The Issuing Bank will receive and review the bill of lading, or other supporting documentation, for conformity with the terms as required in the LOC. The intent behind this routine, of course, is to demonstrate that the goods purchased were in fact shipped from the country of export and received in the country of import. Any variance on the face

of the bill of lading will cause any diligent Issuing Bank to refuse the release of funds, which will have the effect of both preventing payment to the Beneficiary as well as exercise of title by the buyer.



LOCs as Traps for Transporters

Merchandise moving under an LOC is of course carried by an ocean or air carrier and, very likely, arranged and managed by an ocean or air forwarder. Shipping documents are often significant to the fulfillment of an LOC, but those materials are prepared by the transportation providers with often little or no communication regarding the specific terms of the LOC. A transportation provider may, as a result, unknowingly generate paperwork on which the transaction cannot be completed. The subsequent inconvenience burdens both seller and buyer as well as the transportation provider, who then must hold the merchandise and sometimes reissue documentation (even “original” documentation) in the interest of conforming with the newly disclosed LOC terms.

Buyers hold the keys to effectively communicating LOC requirements due to their direct relationship with the Issuing Banks. Buyers must consider the desired shipping terms and ensure that those are reflected in the terms of the LOC. The ports of loading and destination on the shipping documents must match those ports identified in the terms of the LOC. The description of the goods sold on the shipping documents must match the description of the goods denoted on the LOC. The exact documents to be presented for payment under the LOC must be presented at the time of collection. Thus, it is important that the buyer communicate with the seller to ensure alignment on those requirements and avoid supply chain interruption. The party responsible for arranging transportation, whether seller or buyer, must know precisely which terms must be evidenced on the bill of lading in order for the transaction to succeed.

Buyers must also remain cognizant of any changes in the terms of sale or transportation. The terms of an LOC cannot be altered by the Issuing Bank, regardless of the necessity for that change, without the express written consent of the buyer. Thus, if a buyer and its seller make changes to a supply contract that affect the use of an LOC then, if the LOC has already issued, the buyer must instruct the Issuing Bank to amend and reissue the LOC. Any transactional changes that inadvertently cause variance in terms evidenced on the bill of lading, invoice, or other transactional

document must also be considered in terms of the LOC. If those documents do indeed change and are required for presentment, then the Issuing Bank very often may refuse payment on grounds of nonconformity. Some changes may be those that a transportation provider can accommodate, such as updating the legal name of a consignee, but others very well may require an amendment to the LOC terms.

Avoiding Supply Chain Interruptions

Effective communication is paramount due to the varying roles and interests of the many parties to an LOC transaction (seller, Confirming Bank, buyer, Issuing Bank and transportation services providers). The transportation services provider is often in a vulnerable position because it is furthest removed from the LOC terms. Those providers are required to issue bills of lading and other documentation precisely and without deviation from terms found in LOCs-terms that those providers neither negotiated nor had the opportunity to review. No party wishes for merchandise to sit at a receiving port collecting demurrage and other charges while LOCs are renegotiated and documents are reissued. The solution always involves educating the parties, aligning expectations, and bringing clarity to documentary requirements. In all events, if those remedial exercises had occurred in advance through proper communication, then the transactions would have proceeded without interruption.

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[1] Goods in Transit § 2.07 (2018).

[2] <https://www.export.gov/article?id=Letters-of-Credit-and-Documentary-Collection>.