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Margaret L. Moses

Loyola University Chicago, School of Law, mmoses1@luc.edu

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THE IRONY OF INTERNATIONAL LETTERS OF CREDIT: THEY AREN'T SECURE, BUT THEY (USUALLY) WORK

MARGARET L. MOSES

Because payment under a letter of credit depends upon presentation by the seller-beneficiary of documents that comply strictly with the documents required by the letter of credit, the slightest discrepancy in the documents relieves the bank of its obligation to pay. Indeed, most presentations are discrepant. Yet buyers typically waive the discrepancies in the documents, thereby permitting the seller to be paid by the bank under the letter of credit. This article shows how the seller, by controlling the goods through use of a negotiable bill of lading, consigned to the bank, can protect itself from the potential opportunism of the buyer.

Letters of credit are a widely used payment mechanism, particularly in international sales.¹ A seller will require payment by letter of credit because she believes it to be a secure payment device, and she wants to be protected against the risk of non-payment, particularly in the event of the buyer's insolvency, or a drop in market price.² There is an irony in the use of letters of credit, however, since, although they actually work most of the time as an effective payment mechanism, in the majority of cases, the bank is not required to make payment. Because payment under a letter of credit depends

Margaret L. Moses is Assistant Professor of Law, Loyola University Chicago. The author, who may be reached at mmoses1@luc.edu, gratefully acknowledges the comments of Donald Rapson, Esq., Paul Turner, Esq., and Professors Patrick McFadden, David Snyder, Neil Williams, and Michael Zimmer.

upon presentation by the seller-beneficiary of documents that comply strictly with the documents required by the letter of credit, the slightest discrepancy in the documents relieves the bank of its obligation to pay.³ Most presentations are discrepant.⁴ Yet, most buyers waive the discrepancies in the documents, thereby permitting the seller to be paid by the bank under the letter of credit.

Recently published scholarship has focused on this irony and has attempted to explain why buyers waive discrepancies since they have no obligation to do so and since seller's presentation of discrepant documents provides buyer an opportunity to avoid payment under the letter of credit.⁵ This article will add to the discussion by showing how the seller, by controlling the goods through use of a negotiable bill of lading, consigned to the bank, can protect itself from the potential opportunism of the buyer. When the seller maintains control of the goods, the buyer has an incentive to waive the discrepancies in the documents, and therefore permit the bank to pay the seller under the letter of credit.⁶

This article first describes how letters of credit are thought to work. It will then show the reality of how the system works. It next focuses on explanations proposed in recent scholarship as to why buyers tend to waive discrepancies, even though they have no duty to do so. Finally, it explains the role of the bill of lading as a control mechanism.

THE CONVENTIONAL WISDOM OF HOW LETTERS OF CREDIT WORK

Letters of credit are generally considered the most secure payment mechanism in sales transactions, other than cash in advance.⁷ In international sales particularly, where less information may be available to a seller about a buyer's business reputation and financial standing, frequently seller will require buyer to pay by letter of credit, issued by buyer's bank, in order to reduce the risk of non-payment.⁸ The conventional wisdom is that the credit of the issuing bank is substituted for the credit of buyer, thereby assuring payment, because the solvency of the issuing bank is generally more certain than the solvency of a foreign, relatively unknown buyer.⁹ Seller will have an absolute right to payment from the bank under the letter of credit, if, after

shipping goods to buyer, she presents to the bank the documents required by the letter of credit.¹⁰ This payment obligation running from the issuing bank to seller cannot be changed or interfered with by buyer once the letter of credit has been issued. If buyer changes his mind because the market price drops, or he becomes insolvent, or for some other reason he does not want to proceed with the transaction, the issuer will nonetheless have to pay seller upon receiving complying documents. The bank's obligation to pay upon receipt of complying documents is independent both of the underlying obligations between buyer and seller on the sales contract, and of the obligation by buyer to reimburse the bank for any payment it makes under the letter of credit.¹¹ Thus, once seller presents complying documents to the issuing bank, she is assured of payment.

THE REALITY

In practice, the letter of credit is not a very secure payment mechanism. Since documents presented by seller must "strictly comply" with the documents listed in the letter of credit, if there is a single discrepancy between documents presented and documents required, seller's entitlement to payment is extinguished.¹² Banks only deal with documents, not with goods, and have no obligation to investigate or determine if the underlying transaction has actually occurred.¹³ Instead, the bank's obligation is limited to determining whether the required documents, in proper form, have been presented. Courts have found that minor discrepancies, such as the misspelling of a name, or a slightly different description of the goods in the commercial invoice from the description required by the letter of credit, relieve the bank of its obligation to pay seller.¹⁴ In the imperfect world of international commerce, one would expect some documentary presentations to be discrepant. The magnitude of the problem, however, is surprising. Various studies show that the percentage of initial documentary presentations containing discrepancies to be as high as 90 percent.¹⁵ These statistics thus suggest that an issuing bank will only be obligated to pay the seller under a letter of credit in a small percentage of cases. What is also surprising, however, is that even though seller frequently loses the right to be paid under a letter of credit because it presented non-complying documents,

seller's risk of actual non-payment under a letter of credit is generally quite small. While little actual data is available, estimates of the percent of letters of credit that fail completely are only about 1 percent or fewer of letters of credit for which presentations of documents are made.¹⁶ The reason letters of credit generally do not fail more often as a payment mechanism is that one of two things generally happens: either seller corrects the discrepancies prior to the expiry date of the letter of credit, or, more usually, buyer agrees to waive the discrepancies.

COMMENTATORS' VIEWS

Recently, scholarly attention has focused on this disconnect between the conventional wisdom about letters of credit as secure payment mechanisms, and the reality that letters of credit frequently do not secure payment, even though they are routinely paid. In an empirical study of letters of credit in 500 transactions, Professor Ronald Mann found that documents presented did not conform to the letter of credit requirements 73 percent of the time.¹⁷ He also discovered, however, that in almost every case, buyer promptly waived the discrepancies, thereby permitting payment under the letter of credit to occur.¹⁸ Professor Mann's study is valuable in focusing on the puzzle of why sellers continue to use a payment mechanism which frequently depends for its effectiveness on the good will of a buyer. Since seller's right to be paid vanishes if the discrepancies cannot be cured,¹⁹ in the majority of documentary presentations, payment by the bank will occur only if buyer decides to waive the defects in seller's presentations.²⁰ The Mann article raises legitimate questions: (1) why, if the letter of credit does not serve the function it is intended to serve, do businesses continue to use it, and (2) why, if the right to payment is lost, does the letter of credit nonetheless end up being paid in most cases?

Several different explanations were considered by Professor Mann. First, he rejected the theory that businesses which use letters of credit lack an understanding of how they work.²¹ Many of the users of letters of credit in his study were large and sophisticated companies which used letters of credit regularly.²² Moreover, they had options of other payment mechanisms, yet chose to continue using letters of credit.²³ Thus, the mistake story does not

seem to work for these companies.²⁴

Professor Mann also asserted that the classic payment assurance story does not explain why businesses use letters of credit, because the frequency of discrepant documents makes it generally unlikely that an issuer will be obliged to pay under the letter of credit.²⁵ In his view, payment assurance remained part of the story, but other factors were more important.²⁶

The real value of the letter of credit, according to Professor Mann, is as a verification institution.²⁷ By that he means that a bank is in a much better position than seller to obtain financial and reputational information about buyer, and to evaluate buyer's creditworthiness and probity.²⁸ A bank in the normal course is not going to issue a letter of credit at the behest of an insolvent or shady buyer, because the bank depends upon the buyer for reimbursement of the funds paid out under the letter of credit. Thus, the issuance of the letter of credit is an implicit verification of the applicant's reliability and probity.²⁹ The bank's willingness to issue the letter of credit signals to seller that buyer is not likely to act opportunistically to interfere with payment (for example, by refusing to waive discrepancies when seller has fully performed).³⁰ Further, according to Professor Mann, the bank's reputation is on the line, i.e., by issuing the letter of credit, the bank essentially permits the buyer to "rent" its reputation for purposes of the transaction.³¹ In this way, sellers are assured that they are doing business with reliable trading partners, who want to do business, and are not likely to thwart a transaction because of minor documentary discrepancies. Professor Mann thus concluded that when the bank issues a letter of credit, it is essentially predicting that the buyer will perform according to industry norms in the letter of credit transaction.³² This prediction is based both on the bank's ability to assess the buyer's probity, and its belief that it will be able to influence the buyer to waive discrepancies. According to Professor Mann, the possibility that the bank may be able to influence the conduct of the buyer is one of the most important aspects of the letter of credit.³³

Finally, Professor Mann observed that letters of credit may serve indirectly to verify the authenticity of an international transaction.³⁴ He noted that both governments and private lenders use letters of credit as a means of indirect verification of the legitimacy of a particular transaction.³⁵ Thus, for Professor Mann, the main answer to the puzzle is that businesses are in large

part paying fees for the verification function provided by the intermediation of the bank.³⁶

A MISSING PIECE OF THE PUZZLE — THE BILL OF LADING

Professor Mann has certainly done a service in documenting the basic conundrum of a letter of credit: Why do sellers continue to use a payment mechanism which ultimately provides little guarantee of payment, since the vast majority of documentary presentations are discrepant, thereby extinguishing seller's entitlement to payment? And why do buyers tend to waive the discrepancies promptly, which then restores seller's right to payment under the letter of credit?³⁷ Professor Mann has pinpointed a curious aspect of the letter of credit transaction: it generally works, but not in the way it is expected to work or is advertised as working. It works in many cases not because it is a secure payment mechanism, but because buyers agree to let it work.

Since payment in many instances depends on the good will of the buyer, would buyers and sellers be better off if they did not incur bank fees for a letter of credit, and simply transacted business on open account? What purpose does the letter of credit actually serve? While the commentators on Professor Mann's article in the same issue of the Michigan Law Review provided interesting counterpoints to his view that the primary significance of the letter of credit is as a verification institution,³⁸ none commented on a fundamental aspect of the letter of credit transaction which may explain part of the puzzle: the role of the maritime bill of lading as a control device for seller.

A prudent seller in an international sales transaction who has required payment by letter of credit will ship goods CIF (cost insurance freight).³⁹ This means the total invoice value paid by buyer under the letter of credit will include the cost of the goods, the cost of insuring the goods, and the cost of transporting the goods to buyer's port. Seller arranges and initially pays for insurance and freight. The carrier which transports the goods will issue a bill of lading to the party who paid for the carriage, so in the case of a CIF contract, the bill of lading will be issued to seller.⁴⁰ The marine bill of lading is a title document,⁴¹ and in a letter of credit transaction, seller will require it

to be negotiable. A negotiable bill of lading can be consigned to one owner, and can be endorsed over to a new owner, thereby transferring ownership of the underlying goods. The prudent seller, who wishes to maintain control of her goods until she knows whether payment will be made under the letter of credit, will consign the bill of lading to the confirming or issuing bank. The bill of lading is almost always one of the documents required to be presented to the bank under the letter of credit, first, because it provides a means of transferring title from seller to buyer through the intermediary of the bank, and second, because it functions as evidence that the goods have been shipped, which is what buyer wants to occur prior to payment. Even though goods have been shipped, buyer will not be able to obtain possession of them until the bill of lading, properly endorsed over to him, has been provided to him by the bank. By consigning the bill of lading to the bank, seller ensures that if buyer refuses to waive discrepancies, the bill of lading will not be endorsed over to buyer, but will be returned to seller, leaving seller in control of the goods.⁴² If seller does not consign the bill of lading to the bank, but rather uses a non-negotiable bill of lading made out to the buyer, or endorses a negotiable bill of lading to the buyer, this would enable the buyer, now properly in possession of title to the goods, to take the bill of lading to the docks and pick up the goods, whether or not the letter of credit had been honored. The problem for seller when this happens is that once buyer has obtained possession of the goods, his incentive to waive any discrepancies in seller's presentation greatly diminishes.

It is not only in seller's interest, but also in the bank's interest to have the bill of lading consigned to the bank. The bank then holds the goods as security: in the unlikely event that after the bank pays under the letter of credit, buyer does not reimburse it (because buyer is insolvent or the bank has wrongfully honored), then the bank has the right to sell the goods and keep the proceeds. Nonetheless, consigning the bill of lading to the bank is less important for the bank's protection than for seller's protection, because the bank has other ways to protect its interests. Banks should and usually do take appropriate steps to screen the buyer for creditworthiness, and to obtain collateral to secure buyer's reimbursement obligation. A bank can also protect its right of reimbursement by providing in its reimbursement agreement with the applicant that the standard the bank has to meet for reimbursement by buyer

is lower than the standard that seller has to meet for payment by the bank. Buyer must then reimburse the bank if the documents presented have "substantially" complied with the letter of credit requirements, even though the bank will not pay seller unless seller's documents "strictly comply."⁴³ Sellers, on the other hand, have nothing to fall back on, other than the legal process, if they lose both the right to payment under the letter of credit and control of the goods, and buyer is insolvent or refuses to pay.⁴⁴

Professor Mann's data did not establish how often sellers maintained control of the bill of lading (and therefore control of the goods). It is particularly important for sellers to follow this procedure, however, in light of the high percentage of discrepancies in documentary presentations. If buyer were unwilling to waive discrepancies, but seller had maintained control of the goods by consigning the bill of lading to the bank, she would at least have the option of shipping the goods back to the U.S., or trying to obtain another foreign buyer. Although neither option is ideal, both are preferable to losing control of the goods and not being paid under the letter of credit.⁴⁵ In that case, where buyer has possession of the goods, and seller has not been paid, seller's only recourse may be litigation, usually in a foreign jurisdiction. Buyer, of course, may be insolvent and the goods or their proceeds may be in the hands of creditors before seller can begin legal efforts to repossess the goods.

Controlling the bill of lading is therefore key to seller's success in obtaining a waiver of discrepancies from buyer. Professor Mann expected buyers to seize on discrepancies as a basis for withholding or delaying payment, and was surprised when data showed that waivers tended to occur rather promptly.⁴⁶ If buyer does not have possession of the goods, however, and knows he will not obtain such possession until he has waived the discrepancies, he has every incentive to do so promptly. It would be useful to know from the data in Professor Mann's study if any of the buyers who waived promptly were actually in possession of the goods. While it is conceivable that a buyer who already had possession of the goods might waive promptly, such a buyer has more incentive to delay, since delay provides no downside for him. There is even a financial incentive to delay, since delay in paying the letter of credit results in the equivalent delay by the bank in debiting buyer's account.

Thus, a seller who controls her goods by controlling the bill of lading is

better off than one who simply sells on open account. If she is not paid immediately by letter of credit, she still controls the goods, thereby creating an incentive for buyer to promptly waive discrepancies. If seller had sold on open account, she normally would ship the goods with no guarantee of payment, and would generally wait sixty to ninety days to receive payment. If payment was not made, there would be little likelihood of repossessing the goods, and the cost of international litigation might prevent any effective remedy for non-payment.⁴⁷ A seller who maintains control of her goods under a letter of credit, however, will still possess the goods if the payment mechanism fails.

Assuming the seller controls the bill of lading, would she nonetheless be better off using documentary collection, which is a much less expensive payment mechanism than the letter of credit?⁴⁸ In a documentary collection, the seller also presents to the bank documents evidencing shipment of goods, but the bank's function is primarily as a transmitter of documents to a corresponding bank in buyer's country. The corresponding bank will provide buyer with the necessary document of title only if he first pays the bank the agreed invoice price. Neither seller's bank nor the corresponding bank assumes any independent obligation to pay the seller, so if buyer never shows up to pay for the goods, seller will have to have the goods reshipped to the U.S. or find another foreign buyer. This situation appears similar to the case where the buyer in a letter of credit transaction has refused to waive discrepancies, but seller has maintained control of the goods. But the seller who uses a letter of credit nonetheless appears to have an advantage over the seller who uses documentary collection. According to Professor Mann's interviews with various bankers, buyers declined to pay in documentary collection cases approximately 12 percent of the time,⁴⁹ whereas letters of credit applicants refused payment (after discrepancies had been found) less than 1 percent of the time.⁵⁰ This information may support Professor Mann's view that the letter of credit functions as an important verification institution, since banks screen letter of credit applicants more carefully than buyers who pay by documentary collection.⁵¹

Moreover, since some letter of credit presentations are complying,⁵² therefore triggering the bank's payment obligation, buyers in those cases have no ability to interfere with the bank's obligation to pay under the letter of

credit.⁵³ Thus, even though letters of credit do not generally work as advertised, they do provide sellers, particularly sellers who understand how to maintain control of their goods by controlling the bill of lading, with generally more assurance of payment than other frequently used means of payment, such as open account and documentary collection.

Professor Mann's observations that the letter of credit serves as a verification device is an important one. The reason it can serve this function is that banks which regularly issue letters of credit have a standard practice of screening their customers, both for their financial capability and their probity.⁵⁴ Professors Gillette and Katz, however, observe that payment assurance for sellers, as well as shipment assurance for buyers, are still important functions of the letter of credit.⁵⁵ Moreover, a prudent seller who maintains control over her shipment by using a negotiable bill of lading consigned to the bank provides the buyer with an incentive to promptly waive discrepancies, so that drafts under the letter of credit can be paid. Businesses therefore continue to use letters of credit, even though they are not, in most cases, a secure payment mechanism, because in the majority of cases, they work.

CONCLUSION

Although letters of credit do not work the way most people anticipate they will work, they nonetheless function reasonably well most of the time as a payment mechanism for the sale of goods. Professor Mann has provided a partial explanation of why most letters of credit are honored by banks, even in circumstances where seller's discrepant presentation of documents removes the obligation on the banks to do so. Because banks effectively screen out buyers who are not reputable or creditworthy, most buyers who are letter of credit applicants are reliable companies which want to do business, and are not going to object to minor discrepancies in a seller's documents. By waiving discrepancies, they permit the letter of credit to be honored. This article provides an additional explanation for the effective functioning of the letter of credit: the seller's control of the bill of lading works to create an incentive for letters of credit to be paid even in the absence of a duty to pay. Sellers who use letters of credit should understand that if they do not control the goods by maintaining control of the bill of lading, they have increased the

possibility that the letter of credit will not protect them from the risk of non-payment. A buyer who gains possession of the goods, and then learns that there are discrepancies in the documents, can take advantage of the seller simply by delaying any waiver of discrepancies (and thereby delaying a bank debit of his account), or by trying to negotiate a lower price. More empirical work, which could show whether non-payment of letters of credit occurs primarily when sellers have lost control of the goods, would be helpful to show the significance of the bill of lading as a control mechanism.

NOTE

¹ The letter of credit discussed in this article is a commercial letter of credit, which is intended to function as a payment mechanism in sales transactions. The article will not deal with stand-by letters of credit, which function more like a guarantee or a performance bond.

² When seller requires from buyer a letter of credit as a payment mechanism for goods under a sales contract between seller and buyer, buyer must apply to its bank, which will, if it finds buyer creditworthy, issue a letter of credit for the benefit of seller. Before the bank will issue the letter of credit, buyer will have to agree to reimburse the bank for any amount the bank pays seller. The bank then assumes an independent obligation to pay seller under the letter of credit if seller presents to the bank the documents required under the letter of credit. Once the bank issues the letter of credit, buyer cannot stop the bank from paying, if the terms of the letter of credit are met by the seller.

³ UCC Article 5, section 108, provides in pertinent part, "an issuer shall honor a presentation that...appears on its face strictly to comply with the terms and conditions of the letter of credit." See *Alaska Textile, Inc. v. Chase Manhattan Bank*, 982 F.2d 813, 816 (2nd Cir. 1982) ("Because the credit engagement is concerned only with documents, 'the terms and conditions of a letter of credit must be strictly adhered to...'", citing *Corporacion De Mercadeo Agricola v. Mellon Bank Int'l*, 608 F.2d 43, 47 (2nd Cir. 1979).

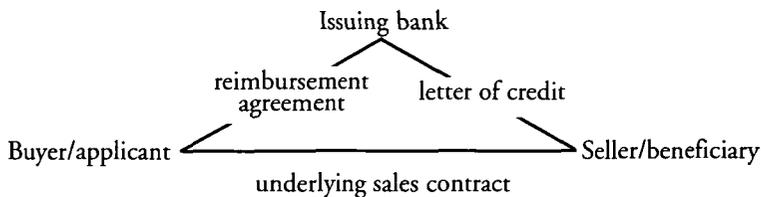
⁴ See Kerry L. Macintosh, *Letters of Credit: Curbing Bad Faith Dishonor*, 25 Uniform Commercial Code Law Journal 3 (1992), citing studies showing that "up to 90 percent of documents initially presented for payment under letters of credit do not comply with stated terms and conditions for payment."

⁵ See Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 Mich. L. Rev. 2494, 2505 (Aug. 2000). Of course, even if the letter of credit is dishonored,

seller still has a contract right against buyer. Collecting from buyer, however, particularly in international sales transactions, can be difficult, expensive, and time-consuming.

⁶ Banks assert that they do not have to accept an applicant's waiver. See official comment 7 to UCC §5-108 ("an issuer may dishonor a noncomplying presentation despite an applicant's waiver."). But if the bank believes it will receive reimbursement from the buyer-applicant, it will as a matter of course agree to waive when buyer waives.

⁷ Banks assert in their sales literature that the letter of credit, after cash in advance, "affords the seller the highest degree of protection from loss." *International Trade Procedures, An Introduction to Doing Business Abroad*, prepared by Core States Bank, 1994, at 5. The letter of credit transaction, viewed in its simplest form, resembles a triangle of obligations.



Assume the bottom leg of the triangle represents the underlying sale of goods contract between buyer and seller. At the top point of the triangle is the bank, which issues the letter of credit to the seller/beneficiary. The right leg of the triangle connecting the bank with the beneficiary, represents the letter of credit, and therefore the obligations running between the bank and the beneficiary. The left leg of the triangle is the reimbursement agreement between the buyer and the bank, in which the buyer promises to reimburse the bank, once the bank has paid under the letter of credit. Each leg of the triangle represents a different set of obligations, which, under the "independence principle," described *infra* note 11 and accompanying text, is completely independent from obligations represented by the other two legs of the triangle. Once the seller/beneficiary has shipped the goods, if she presents the proper documents required by the letter of credit to the bank, she will be paid, even before the goods have arrived in buyer's port. The buyer, however, has assurance that the goods have been shipped, because the documents required to be presented to the bank typically include the bill of lading, the commercial invoice, the certificate of insurance and other documents evidencing shipment.

⁸ See *Alaska Textile* at 815 (court describes hypothetical situation where Japanese buyer allays fear of non-payment of New York seller by arranging for bank to issue

irrevocable letter of credit.)

⁹ *See id.* ["The commercial letter of credit...is a common payment mechanism in international trade that permits the buyer in a transaction to substitute the financial integrity of a stable credit source (usually a bank) for his own."]

¹⁰ In this article, I have adopted the convention of referring to seller/beneficiaries by the female pronoun, buyer/applicants by the male pronoun, and banks by the neuter pronoun.

¹¹ UCC §5-103(d) provides, "Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary." In the Uniform Customs and Practices for Documentary Credits, publication number 500 ("UCP" or "UCP 500"), which are the rules published by the International Chamber of Commerce that are incorporated into almost all letters of credit, the independence principle is found in Article 3(a) and (b): "a. 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. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfill any other obligation under the Credit, is not subject to claims or defenses by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary. b. A Beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank."

¹² *See infra* note 14.

¹³ *See* Article 4, UCP 500, "In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate."

¹⁴ *Beyene v. Irving Trust Co.*, 762 F.2d 4, 6-7 (2d Cir. 1985) (Spelling name of party to be notified as "Soran" rather than "Sofan" was sufficient basis for bank to refuse documents); *Bank of Cochín, Ltd. v. Manufacturers Hanover Trust Co.*, 612 F. Supp. 1533, 1541 (S.D.N.Y. 1985) (omission of LTD., from corporate name justified rejection); *Courtaulds North America v. N.C. National Bank*, 528 F.2d 802, 803, 806 (1975) (Invoice stating goods were Imported Acrylic Yarn did not satisfy letter of credit requirement for invoice covering 100 percent acrylic yarn, even though attached packing list stated 100 percent acrylic yarn).

¹⁵ *See supra* note 4. *See also* James Byrne, "UPDATE Reader Survey Brings Out Reactions to Minor Discrepancies," Letter of Credit Update, July 1987, at 14 (reporting that the majority of respondents in the survey estimated that 90 percent

of documentary presentations contained discrepancies, but that the number of presentations ultimately rejected was 1 percent or less); and “Discrepancies Plaguing Banks’ L/C Operations, New Survey Learns,” December 1988, at 10. (Poll of seven banks revealed range of discrepant documentary presentations from 30 to 90 percent. No more than 1 percent dishonored because in most discrepant presentation, discrepancies are either corrected or waived). *See also* Letter of Credit Management and Control, published by SITPRO in 1985, subtitled: “A Midland Bank Survey on errors in Letter of Credit documentation, with SITPRO conclusions on the cost and risk to exporters, and methods of reducing them”[hereinafter, “SITPRO Study”]. SITPRO’s conclusions begin on page 16 of the report. (49 percent of documentary presentations rejected on first presentation because of discrepancies). SITPRO is the U.K.’s trade facilitation agency, dedicated to helping simplify the international trading process. SITPRO can be reached at www.sitpro.org.

¹⁶ *See id.*

¹⁷ *See Mann, supra note 5 at 2502.*

¹⁸ *See id.* at 2513-15.

¹⁹ An example of a discrepancy which cannot be cured is a date on a bill of lading showing a later date of shipment than the date required by the letter of credit.

²⁰ In the typical case, if buyer did not waive discrepancies in the documents presented, and if the bank paid seller despite discrepancies, the bank would lose its right to reimbursement by buyer. Generally, under the reimbursement agreement between buyer and the bank, buyer is not obligated to reimburse the bank for paying under the letter of credit unless the documents presented to the bank complied with the terms of the letter of credit.

²¹ *See Mann, supra note 5 at 2515-16.*

²² *See id.* at 2516.

²³ *See id.* at 2516-18.

²⁴ *See id.* at 2515, 2519.

²⁵ *See id.* at 2519.

²⁶ *See id.* at 2521.

²⁷ *See id.*

²⁸ *See id.* at 2521-23.

²⁹ *See id.* at 2521.

³⁰ *See id.* at 2498.

³¹ *See id.* Professor Mann also concluded that “banks effectively vouch for their customers when they issue letters of credit for them.” *Id.* at 2524-25. This conclusion was based in large part on conversations with bankers who stated that “the bank’s reputation was at risk whenever their customers refuse to waive discrepancies.” *Id.* at 2525. In addition, Professor Mann observed that several bankers “reported that they

persuaded or pressured customers to waive discrepancies in any case in which the seller's performance was not *seriously* defective". *Id.* Bankers also reported cases where they would refuse to continue to deal with customers who would engage in a pattern of refusing to waive discrepancies. *See id.* at 2526-27.

³² *See id.* at 2528.

³³ *See id.* at 2529. Professor Clayton Gillette, who commented on Professor Mann's article in the same issue of the Michigan Law Review, expressed concern that the methodology used may have produced a suspect result, since Professor Mann only spoke with bank officials, whose statements appear self-serving, and may not tell the whole story. *Letters of Credit as Signals*, 98 Mich. L. Rev. 2537, 2546-47 (August, 2000).

³⁴ *See* Mann, *supra* note 5 at 2530.

³⁵ *See id.* at 2530-32.

³⁶ Two commentators on Professor Mann's article in the same issue of the Michigan Law Review had a different point of view. Professor Gillette was not persuaded that the letter of credit's primary function is that of a verification institution, which he describes as a signaling device. *See* Gillette, *supra* note 33, at 2541. If signaling is a primary function, it means that creditworthy buyers undertake the significant cost of a letter of credit in order to signal that they are more credible than other buyers. *See id.* Professor Gillette noted that the letter of credit is actually a relatively poor source of information, and as a signal, is rather opaque, particularly if compared with other signaling systems, for example, graded ratings of securities by intermediaries. *See id.* at 2543. He suggested that information about a buyer's creditworthiness and legitimacy can be obtained more cheaply and simply in other ways, for example, through trade associations, Dun & Bradstreet reports, and other intermediaries. *See id.* at 2543-44. Professor Avery Katz similarly observed that there are many different legal and commercial institutions available to serve an accreditation function, namely, secured credit, contractual guaranty, posting of a bond, use of contractual intermediaries, and direct acquisition of knowledge. *Informality as a Bilateral Assurance Mechanism*, 98 Mich. L. Rev. 2554, 2557-58 (Aug. 2000).

³⁷ In a letter of credit transaction, generally the seller of goods is the beneficiary of the letter of credit, and the buyer of goods is the applicant, although more complicated arrangements can occur. For purposes of simplicity, in this article all references to seller or to beneficiary refer to the seller as beneficiary, and references to buyer or to applicant refer to the buyer as applicant. In some brochures published by banks explaining letters of credit, the banks will refer to buyer as the importer, and to seller as the exporter. Banks also sometimes refer to the entity opening the letter of credit as the "account party."

³⁸ The symposium issue, 98 Mich. L. Rev. No. 8 (Aug. 2000) had as its general

topic, *Empirical Research in Commercial Transactions*. In that issue, Professor Clayton Gillette noted that while the claim that letters of credit fill informational gaps is highly plausible, in his view, the traditional payment assurance story still represents the primary function of letters of credit. See Gillette, *supra* note 33, at 2537-39. In addition to Professor Gillette and Professor Avery Katz, the commentators for Professor Mann's article included Jacob I. Corre, *Reconciling the Old Theory and the New Evidence*, at 2548.

³⁹ See INCOTERMS 2000, ICC Publication No. 560. This publication defines the commercial terms generally used in international trade. When an international contract specifies that INCOTERMS apply, courts will use these definitions in interpreting the contract. If INCOTERMS are not specified, a court may still apply the INCOTERMS as trade usage, or may use a definition under the applicable law, which may differ from the INCOTERMS definition.

⁴⁰ This discussion is focused on the marine bill of lading, which is a document of title. See UCC §1-201(15).

⁴¹ See *id.*

⁴² Both Article 5 of the Uniform Commercial Code ("UCC"), which governs letters of credit, and Article 14 of the Uniform Customs and Practices for Documentary Credits, publication number 500 ("UCP" or "UCP 500"), which are the rules published by the International Chamber of Commerce that are incorporated into almost all letters of credit, make clear that if the documentary presentation is dishonored, the bank is obligated to return the documents to the seller, or to hold them at seller's disposal, and not provide them to buyer. UCC §5-108(h) provides as follows: "An issuer that has dishonored a presentation shall return the documents or hold them at the disposal of, and send advice to that effect to, the presenter." UCP Article 14(e) provides: "If the Issuing Bank and/or Confirming Bank, if any, fails to act in accordance with the provisions of this Article and/or fails to hold the documents at the disposal of, or return them to, the presenter, the Issuing Bank and/or Confirming Bank, if any, shall be precluded from claiming that the documents are not in compliance with the terms and conditions of the Credit."

⁴³ UCC §5-108 cmt.1 ("...issuers can and often do contract with their applicants for expanded rights of reimbursement. Where that is done, the beneficiary will have to meet a more stringent standard of compliance as to the issuer than the issuer will have to meet as to the applicant."). See also Paolo S. Grassi, *Letter of Credit Transactions: The Banks' Position in Determining Documentary Compliance. A Comparative Evaluation Under U.S., Swiss, and German Law*, 7 Pace Int'l L. Rev. 81, 116-117, 123-124 (standard relaxed between issuer and customer, but strict between issuer and beneficiary). Professor Boris Kozolchik has noted that "a growing number of issuing banks insert clauses in their application agreements that authorize pay-

ment and reimbursement regardless of discrepancies". *Strict Compliance and the Reasonable Document Checker*, 56 Brooklyn L. Rev. 45, 47 (1990).

⁴⁴ One way sellers lose control of the goods is by not consigning a marine bill of lading to the bank. But sellers may also lose control of the goods when they ship by truck or by air. Truck bills of lading and airway bills are not title documents, so buyer generally does need a properly endorsed copy to pick up the goods. In some instances, however, the seller-shipper may be able to work out some form of control with the air or truck carrier. See Boris Kozolchyk, *The UNIDROIT Principles as a Model for the Unification of the Best Contractual Practices in the Americas*, 46 Am. J. Comp. 151, 156-60 (1998) for a discussion of NAFTA truck bill of lading law and practice. Professor Kozolchyk points out that between Canada and the United States, although the truck bill of lading is only a receipt of shipment, and not a title document, the shipper-consignor retains some control over goods in transit because she can stop delivery and reroute the goods if she notifies the carrier in time. at 156. In Mexican practice, on the other hand, "Despite the fact that the truck bill is not supposed to be a document of title, it is used by carriers and consignees as a freight invoice that acts both as a document of title and a receipt of payment of the freight." at 158. When a shipper uses air transport, she may decide *not* to attempt to maintain control of the goods, because the goods will arrive very quickly, and if there is any delay to the buyer in picking up the goods (i.e., while the bank is determining whether to waive discrepancies), demurrage charges will accrue. When a seller decides to use airlines or trucks for transporting goods, if she cannot establish a reasonable method of retaining control of the goods in the event the letter of credit is dishonored, she may be better off using a payment mechanism other than the letter of credit.

⁴⁵ This would occur if buyer got possession of the bill of lading, which enabled him to obtain possession of the goods, and then refused to waive discrepancies in seller's presentation of documents. While seller would still have rights against buyer under the sales contract, the buyer might be insolvent, or might be in a country where there is not a lot of hope of due process. In any event, the cost of international litigation might make the claim not worth pursuing. Even if recovery was pursued and realized, it would occur much later in time, at substantial cost.

⁴⁶ See Mann, *supra* note 5, at 2513-15.

⁴⁷ Although a substantial amount of international business is done on open account, this payment term is generally used between parties with strong, long-term relational ties. Professor Mann refers to data suggesting that cross-border sales of goods transactions coming into or out of the United States use letters of credit in 13 percent of transactions, open account in 72 percent, documentary collection in 4 percent and cash in advance in 2 percent. Another source referred to by Professor Mann

reported 29 percent of such transactions used letters of credit, 52 percent open account, 7 percent documentary collection, and 12 percent cash in advance. *See* Mann, *supra* note 5, at 2518, n.78. In any case, open account transactions are the predominant way of conducting international sales.

⁴⁸ Professor Mann noted that bank fees for documentary collections are typically in the range of \$100-\$300, while for letters of credit, the fees may be approximately one-quarter of one percent of the face amount of the letter of credit, or \$2500 on a \$1,000,000 sale of goods. *See* Mann, *supra* note 5, at 2499, 2518, notes 76-77.

⁴⁹ *See id.*, at 2518, n.75.

⁵⁰ *See id.*, at 2513-14.

⁵¹ Banks are not as likely to screen customers for a documentary collection because banks take little, if any, risk in acting merely as a transmitter of documents and funds. In a documentary collection, the bank has no independent obligation to pay. It merely transmits buyer's funds to seller.

⁵² Mann found the following conformity rates: 26 percent at the Midwest Bank, 17 percent at the Mid-Sized Northeast Bank, 29 percent at the West-Coast Bank, 27 percent at the Foreign Bank, and 36 percent at the Major Northeast Bank. *See* Mann, *supra* note 5, at 2502, n.30.

⁵³ There is a narrow exception for fraud. Under UCC §5-109, an applicant with evidence of material fraud may be able to persuade a bank not to honor. Unless an issuer is obligated to honor under §5-109(a), however, it has the choice to honor or dishonor, if it acts in good faith. An applicant with good evidence of material fraud may be able to persuade a court to enjoin the bank from honoring drafts under a letter of credit. §5-109(b).

⁵⁴ *See* Mann, *supra* note 5, at 2526, 2529.

⁵⁵ *See* Gillette, *supra* note 33, at 2539, Katz, *supra* note 36 at 2564-65.