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PAYMENT

Introduction to the Methods of Payment Involving Banks

by William C. Edwards, Jr.*

As we draw to the conclusion of a discussion about the problems and remedies encountered in drafting an international sales contract, it is fitting that we arrive at the subject of payment. This is the ultimate goal for which the sales contract came into existence. Ideally, payment should be that happy event that occurs when a seller of goods and services receives full and timely settlement from the buyer in accordance with their agreement. It is an event in which a commercial bank is almost always involved, although the extent of its involvement may vary widely from transaction to transaction.

The available methods of payment are:[1]

I. Cash in advance
II. Open account
III. Collections
  A. Clean
  B. Documentary
IV. Letters of credit

The process of selecting the best method of payment, whether it be one of those mentioned above or a combination of methods, includes an evaluation of risk and competition in order to reach a decision on how best to deal with them. An international transaction contains some degree of political risk for the seller that is not present in a domestic transaction. Generally, political risks are those that would result in the failure of a buyer to pay the seller because of (1) war hostilities, civil war, rebellion, insurrection or civil commotion; (2) expropriation, confiscation or similar action by government; (3) the imposition by government author-

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[1] *See* P. HORN & H. GOMEZ, INTERNATIONAL TRADE PRINCIPLES AND PRACTICES 465-82 (4th ed. 1962); C. SCHMITTHOFF, THE EXPORT TRADE 205-36 (6th ed. 1975). A practical guide to banking requirements is found in G. REIMANN & F. WIGGLESWORTH, INTERNATIONAL GUIDE TO FOREIGN COMMERCIAL FINANCING 6-99 (1961). *See also* PRACTICING LAW INSTITUTE, INTERNATIONAL BANKING 1977: CURRENT PROBLEMS AND CHALLENGES (1977).

ity of any order, decree or regulation of general applicability having the force of law; or (4) the failure of the central exchange authority to transfer local currency into dollars. For an illustration of the reality of these risks, one only has to look at the recent disturbances in Lebanon. I know of one instance there in which goods were destroyed in the fighting after being unloaded on the dock. The buyer had disappeared and insurance failed to cover the seller's loss. Another example is Turkey, where economic conditions have forced a decline in its holdings of dollars and other hard currencies. Hence, it is unable to allocate these currencies to importers so that they may make payment for goods and services already delivered or under contract.

An evaluation of risk also includes the evaluation of the financial standing and reputation of the buyer in order to establish his ability and willingness to pay. The buyer should make a similar evaluation because the financial standing and reputation of the seller will establish his ability to deliver goods or services as agreed.

Full or substantial payment in cash in advance relieves the seller of most, if not all, of the risk of nonpayment. However, this occurs only in extreme cases since competition from other sellers will often enter the picture. A seller insisting on such terms will usually find himself losing a sales opportunity to other sellers who are willing to offer more liberal terms. Unless the circumstances are extreme, the buyer is unwilling to pay for something he has not yet received and assume the risk of nondelivery. This method of payment is self-explanatory and needs no further comment.

Open account terms are quite common in international transactions, particularly when the buyer is known by the seller and is located in a country that is economically strong and politically stable. These terms often provide for a simple contractual agreement that may be accomplished orally or in written form. The export of tobacco, so important to this region of the world, is usually accomplished with little in the way of written contracts. The seller relies entirely upon the buyer's willingness and ability to pay at some mutually agreed point in time, which is after goods or services are in transit or have been delivered. This method of payment is quite simple since it entails only the transfer of funds by wire or draft from the buyer to the seller. It is the most competitive of all payment methods, but it is also the one involving the greatest risk.

The collection method of payment is a middle route by which some, but not all, of the risk may be removed from the international transaction. The term "collection" envisions the completion of a draft or bill of exchange drawn by the seller on the buyer and lodged by the seller with his bank. The draft or bill of exchange is accompanied by written instructions that will govern its presentation to the buyer through banking channels. A "clean collection" is a draft without attached documents. A

"documentary collection" is a draft to which shipping documents are attached, including the bill of lading which conveys title to the goods.

Drafts, whether they be clean or documentary, may be drawn on the buyer at sight or at a stated number of days from date or sight, but the choice should be agreed upon in advance. Sight drafts call for payment upon presentation to the buyer and if documents are attached, the seller's instructions are to release such documents against payment. Drafts which are drawn payable at a stated number of days from date or sight require release of documents against acceptance of the draft by the buyer. In order to constitute an act of acceptance, the buyer must write the word "accepted" across the face of the draft, write the date on which acceptance occurs and finally sign the draft as drawee. By doing this the buyer acknowledges the debt and promises to pay it at its maturity.[2]

Whether it be drawn at sight or payable at some future date, a dishonored clean draft affords little protection to the seller. In fact, it is not much different from an open account arrangement, especially if the seller has given the buyer a means of access to the goods. On the other hand, if the draft has been signed by the buyer and forwarded to the seller in settlement for goods or services purchased and then entered by the seller for collection at the bank as a clean draft, dishonor upon presentation to the buyer provides the seller with a legal cause of action to recover.[3]

Where documents, particularly bills of lading in negotiable form conveying title to goods, are attached to a draft, the seller can retain title until such time as payment is received at the point of collection. If the draft is a time draft, title is retained until the draft is accepted by the buyer who thereby acknowledges his obligation and promises to pay at maturity.

Release of shipping documents against payment is another method which removes the seller's risk of nonpayment. This assumes that the

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[2] U.C.C. § 3-410 entitled "Definition and Operation of Acceptance" provides:

> (1) Acceptance is the drawee's signed engagement to honor the draft as presented. It must be written on the draft, and may consist of his signature alone. It becomes operative when completed by delivery or notification. . . .
>
> (3) Where the draft is payable at a fixed period after sight and the acceptor fails to date his acceptance the holder may complete it by supplying a date in good faith.

N.C. GEN. STAT. § 25-3-40 (1965) is identical. The safest and least dangerous method for the buyer to accept is to provide for all contingencies by writing "accepted" across the draft, and signing and dating it.

[3] "If the draft is drawn upon and accepted by a bank, it is a banker's acceptance. If it is drawn on and accepted by one other than a bank or banker, it is called a trade acceptance. There is no distinction in law . . . [but] [t]here is . . . a world of difference in practical effect. Where the credit of a purchaser . . . is insufficient, . . . a draft offers an opportunity—through the process of acceptance—to engage credit of a third party. . . . In effect, when a draft is accepted, it becomes a promissory note by the drawee, on which the drawer is liable as an endorser. Thus, a draft that has been accepted by a banker, and which stands in the position of a promissory note issued by a bank, is ordinarily a more valuable piece of paper than one that has been accepted by a merchant. . . ." Harfield, *Letters of Credit and Other Forms of Trade Financing*, in INTERNATIONAL BANKING 1977, *supra* note 1, at 19-20.

seller has met all of his responsibilities with respect to the goods or services and is not subject to legal action brought by the buyer to recover all or a portion of his payment. However, there is still a risk for the seller even though he retains title to his goods until payment, for if the buyer refuses to pay, the seller must find another buyer or arrange for the return of the goods. This problem is complicated in an international transaction because of several factors: the distance usually involved in the transport of goods; the necessity of finding adequate storage until other arrangements can be made; the necessity of dealing with the customs regulation of the country of destination both as to the entry of the goods and the re-export of them; the possibility of spoilage if the goods are perishable; and the expense incurred for transportation, storage, and insurance and other necessities.

These risks of an international transaction are heightened if the seller has agreed to release documents against acceptance of a time draft, despite the fact that he would then hold evidence of the buyer's acknowledgement of the debt and promise to pay at maturity. The passing of title from seller to buyer against acceptance of a time draft by the buyer is a form of financing the transaction. The purpose of this procedure is to give the buyer access to goods and time to resell them before payment to the seller is due. This procedure may have evolved over a period of time as a custom of a particular trade or it may be forced upon the seller to meet the competition. The accepted draft affords the seller a stronger legal position than in an open account sale, but he is still dependent upon the buyer's ability and willingness to pay after the title to his goods has passed.

Sellers often instruct their banks to protest drafts for nonpayment or nonacceptance. The effect of this may vary, particularly where the drawee has a strong argument that the drawing is unwarranted. But an entirely different situation is presented where the draft has been accepted and then is dishonored for nonpayment. The drawee's position is further eroded if a bank has discounted the draft and has become a holder for value. Mr. Gallant will discuss protest and its effect on these transactions in the following presentation.

Unfortunately, the dishonor of a sight draft and the nonacceptance of a time draft often have nothing to do with the buyer's ability to pay. Dishonor may arise because of a misunderstanding or disagreement over such matters as which party is responsible for bank charges, whether the buyer has the privilege of inspecting the goods before payment or acceptance, the levying of interest charges by the seller, etc. I cannot overemphasize the importance of the buyer and seller covering such points as these in their preliminary negotiations and the final draft of the sales contract.

I have already mentioned some of the risks the seller faces if a buyer refuses to pay, even though the seller retains title to his goods. One more

risk should be mentioned. The U.S. dollar is used less frequently as the medium of exchange in international commercial transactions. Where a seller has agreed to accept payment in the buyer's currency, any delay in payment subjects the seller to a loss due to fluctuation in exchange rates. He may be in a position to gain as well, but these are speculations a seller prefers to avoid.

In summary, the method of payment which involves the collection of a draft drawn by the seller on the buyer and which is accompanied by documents conveying title to merchandise affords some protection to the seller in the event of nonpayment. However, many pitfalls remain. In spite of the pitfalls, this method is commonly used and affords some compromise by both buyer and seller relative to risk and competition.

I come now to the final method of payment under discussion—letters of credit.[4] Although this method is not perfect in the eyes of both the parties to an international commercial transaction, it does remove much of the risk of nonpayment and can be provided by the buyer without significant additional cost. It should be used wherever the credit worthiness and reputation of the buyer cannot be reasonably established or whenever either have deteriorated during an existing commercial relationship which employs one of the other payment methods. The letter of credit should also be required if the sale involves a valuable product requiring several weeks or months to manufacture, especially if the product is of custom design with little market value to others. If the sale involves a buyer located in a country with economic or political problems, a letter of credit may afford the only acceptable method of payment, if indeed a sale should be made at all. A letter of credit may be required by the government of the foreign country itself as an aid to its management of foreign currency reserves and in its allocation of priorities governing the goods and services to be imported.

A letter of credit issued by a bank (opening bank) is drafted in letter form addressed to the seller (beneficiary) and represents an undertaking by the opening bank to pay up to a stated amount of money provided two events occur: (1) the bank is provided with specified documents covering the shipment of specified goods (or performance of services) as described in the letter of credit within a stated shipment date (or performance date); and (2) a drawing under the credit occurs on or before a stated expiration date.[5] The letter of credit may be issued in

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[4] *See id.* 13-20; P. HORN & H. GOMEZ, *supra* note 1, at 471-82; C. SCHMITTHOFF, *supra* note 1, at 215-37; G. REIMANN & F. WIGGLESWORTH, *supra* note 1, at 9-14; A. LOWENFELD & T. EHRLICH, INTERNATIONAL PRIVATE TRADE 90-129 (1975).

[5] INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 290, UNIFORM CUSTOMS AND PRACTICE FOR COMMERCIAL DOCUMENTARY CREDITS (rev. ed. 1974) [hereinafter cited as U.C.P.] provides in General Provisions and Definitions (b) that:

> For the purposes of such provisions, definitions and articles the expressions "documentary credit(s)" and "credit(s)" used therein mean any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and accordance with the instructions of a customer (the applicant for the credit),

either revocable or irrevocable form, but from a practical standpoint the revocable form is seldom seen.

It may be well to make some general comments about the letter of credit at this point. An important characteristic of the letter of credit is that it substitutes the bank's credit for that of the buyer. In addition, if it is issued in irrevocable form, none of its conditions may be altered without the agreement of all the parties.[6] A letter of credit does not meet the test of a negotiable instrument, one reason being that it does not provide an unconditional promise to pay.[7] However, it may be transferred in whole or in part to other parties if the instrument expressly states that it is transferrable.[8]

The letter of credit has been utilized for many years and although it can be useful in domestic transactions, it is generally identified with international commerce. A set of governing rules has developed over a period of time and has been published as the Uniform Customs and Practice for Commercial Documentary Credits.[9] These rules are recognized throughout the free world. Letters of credit, regardless of the nationality of the issuing bank, will contain language which states that the instruments are subject to these rules.

Within the United States, Article V of the Uniform Commercial Code controls payment by letters of credit. It is interesting to note, however, that the Uniform Commercial Code (UCC) of the state of New York, this country's financial center for international trade, defers to the Uniform Customs and Practice whenever letters of credit state that they are subject to those rules.[10] North Carolina does not go quite that far,

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(i)is to make payment to or to the order of a third party (the beneficiary), or to pay, accept or negotiate bills of exchange (drafts) drawn by the beneficiary, or (ii)authorizes such payments to be made or such drafts to be paid, accepted or negotiated by another bank,

against stipulated documents, provided that the terms and conditions of the credit are complied with.

U.C.C. § 5-103(a) defines "letter of credit" as an "engagement by a bank or other person . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit." N.C. GEN. STAT. § 25-5-103(a) is identical. Hence, any conditions may be placed on the letter of credit, and the letter of credit is a "binding undertaking to pay money on the terms and conditions that the banker has stipulated in the letter of credit, and upon no other terms." INTERNATIONAL BANKING 1977, *supra* note 1, at 16.

[6] U.C.P., *supra* note 5, art. 3(a); U.C.C. § 5-106(2); N.C. GEN. STAT. § 25-5-106(2) (1965).

[7] INTERNATIONAL BANKING 1977, *supra* note 1, at 17. Under U.C.C. §§ 5-109(2), 5-114(1) and N.C. GEN. STAT. §§ 25-5-109(2), 25-5-114(1), if the terms of the letter of credit are not strictly complied with, the issuer may dishonor the demand for payment. On the other hand, "a draft drawn under a letter of credit is, ordinarily, a negotiable instrument and is governed, unlike the letter of credit contract itself, by the law of negotiable instruments." INTERNATIONAL BANKING 1977, *supra* note 1, at 18.

[8] *See* U.C.P., *supra* note 5, art. 46(d); U.C.C. § 5-116(1); N.C. GEN. STAT. § 25-5-116(1) (1965) (amended 1975) is identical with the U.C.C. provision.

[9] U.C.P., *supra* note 5.

[10] N.Y. U.C.C. LAW § 5-102(4) (McKinney 1964).

but an analysis of its Article V[11] reveals that it was drafted without contradicting the rules of the Uniform Customs and Practice. I am not certain how other states treat letters of credit, but I am confident that there is very little conflict with the Uniform Customs and Practice. The imposition of laws conflicting with the rules stated in the Uniform Customs and Practice would undermine the worldwide understanding of the procedures dealing with letters of credit. The lack of such conflict ensures that the Uniform Customs and Practice will continue to work effectively and make letters of credit popular and useful.

A copy of the Uniform Customs and Practice is an invaluable reference should you have any dealings with letters of credit. Time does not permit me to go over each of the articles, but I do want to emphasize those rules which apply to some of the most frequent misunderstandings about letters of credit. Article 8 states, "In documentary credit operations all parties concerned deal in documents and not in goods."[12] Furthermore, Article 9 states that:

> Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing delivery, value of existence of the goods represented thereby, or for the good faith or acts and/or omission, solvency, performance or standing of the consignor, the carriers or the insurers of the goods or any other person whomsoever.[13]

Importers often want banks to insert extensive technical descriptions of goods within letters of credit and impose conditions on the seller that should properly be covered in the sales contract. In other words, there are tendencies toward making the letter of credit both a financing instrument and a sales contract. What is overlooked is the fact that the bank is dealing in documents and not in goods. If the beneficiary of the letter of credit provides documents, no matter how detailed, the bank is obliged to pay, provided the documents are in proper form and regardless of whether the goods exist or actually conform to the descriptions contained in the documents.[14] Any beneficiary with larceny in his heart and a

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[11] N.C. GEN. STAT. §§ 25-5-101 *et seq.* In particular, N.C. GEN. STAT. § 25-5-102(3) (1965) states:

> This article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this chapter or may hereafter develop. The fact that this article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this article.

But see the North Carolina Official Comment specifically refusing to adopt the New York rule.

[12] U.C.P., *supra* note 5, art. 8(a). *See also* U.C.C. § 5-114(1); N.C. GEN. STAT. § 25-5-114(1) (1965).

[13] U.C.P., *supra* note 5, art. 9. *See also* U.C.C. § 5-109(2); N.C. GEN. STAT. § 25-5-109(2) (1965).

[14] U.C.P., *supra* note 5, art. 9; U.C.C. § 5-109; N.C. GEN. STAT. § 25-5-109 (1965); Courtaulds N. America, Inc. v. North Carolina Nat'l Bank, 528 F.2d 802 (4th Cir. 1975) (drawee bank is involved only with documents, not with merchandise).

good typewriter can supply almost any documents a letter of credit may reasonably require. He then may receive payment for them whether they have any true relationship to the goods or not. A concept which is often misunderstood is that letter of credit procedure does *not* contemplate inspection of goods prior to payment.

Misunderstandings also arise from the beneficiary's end of the transaction. These may occur when the requirements of the letter of credit are treated casually or when documents are prepared using wording at variance with that called for in the letter of credit. Surveys among banks reveal that about sixty percent of all letter of credit transactions have discrepancies in the documents. The effect of these discrepancies is the bank's refusal to pay or at least a delay in paying while the bank consults with the buyer to determine if the discrepancies can be waived. Discrepancies sometimes arise where the beneficiary, in determining whether he can meet all of the letter of credit's requirements, does not examine the letter of credit carefully when it first comes into his hands. Amendments changing the conditions of letters of credit are permissible, provided all of the parties to the instruments agree.[15] If a beneficiary is unable to perform, it is much better to seek early revision through an amendment than to submit documents containing discrepancies.

A letter of credit is only as good as the ability of the issuing bank to honor its commitments thereunder. Banks do fail! For example, letter of credit obligations of the U.S. National Bank in San Diego at the time of its failure became a major issue between the Federal Deposit Insurance Corporation and the beneficiaries of the credits. Almost every year people mistakenly rely on credits which are fraudulently issued by persons using names similar to well-known banks.

It is incumbent upon the beneficiary of a letter of credit to make certain that he has a genuine instrument issued by a reliable bank. His own bank can help supply needed information, but if there is any doubt, the beneficiary should insist upon "confirmation" by a trustworthy bank in his own country. The word "confirmation" as used in letters of credit means that the confirming bank adds its own undertaking to that of the issuing bank to honor drawings under the credit when made in conformance with the credit's terms. The beneficiary would then have two banks behind the instrument. Confirmation should also be requested if the issuing bank is located in an unstable country where the convertibility from the buyer's currency into the currency of the credit may be endangered. In essence, confirmation relieves the beneficiary of the commercial and political risk which may be inherent in a letter of credit transaction but difficult to assess.

The methods of payment employed in international commerce have infinite variations and there is room for imaginative construction of the

[15] U.C.P., *supra* note 5, art. 3(c); U.C.C. § 5-106(2); N.C. GEN. STAT. § 25-5-106(2) (1965).

payment procedures by the parties. Time does not permit me to go into more detail and I have attempted only to describe the central theme present in each method.

Question and Answer

Question: What protection is added by obtaining confirmation of a letter of credit by a second bank?

Mr. Edwards: A confirmation of a letter of credit by the second bank simply adds its undertaking to honor drawings under terms that were originally promulgated by the issuing bank. The fact that the second bank enters the picture as a confirming bank alters nothing in the way of the terms of the credit, the time in which the payment will be made or any other conditions. Confirmation simply adds more strength to the credit standing of the transaction.

Question: Is it permissible for the buyer to stipulate that the bank is not to pay until it receives a certificate from the buyer indicating that inspection has been satisfactory?

Mr. Edwards: No, it is not permissible. In this case, we are getting the sales contract and the letter of credit intermingled, and we are beginning to deal in goods and not in documents. It is a fact that when these documents are presented, the ship may still be at the dock of departure. The documents may come by air mail and arrive in the bank maybe two to three or even six weeks before the arrival of the goods. I cannot remember specifically the requirement, but banks have to pay or turn down payment within so many hours after three business days. This, of course, does not permit inspection of the goods.