Summer 1986

Primer on Trade Finance: Export Drafts, Letters of Credit, and Banker's Acceptances

Michael Sandler
Barbara Di Ferrante

Follow this and additional works at: https://scholarship.law.unc.edu/ncilj
Part of the Commercial Law Commons, and the International Law Commons

Recommended Citation
Available at: https://scholarship.law.unc.edu/ncilj/vol11/iss3/10

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Journal of International Law by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
Primer on Trade Finance: Export Drafts, Letters of Credit, and Banker’s Acceptances

Michael Sandler* and Barbara Di Ferrante**

This article introduces some of the instruments used to finance international trade: the export draft, the letter of credit and the banker’s acceptance. Unlike some writings in this field, this overview is not written from the perspective of a bank or a bank's lawyer. Rather, it attempts to place these finance mechanisms into the overall scheme of international trade transactions. Because this is an introductory piece, the discussion has been simplified. For those interested in studying the area further, there are a number of works that may be consulted.

I. Documentary Sales: Export Drafts

Any international sales transaction poses inherent payment obstacles. Buyers and sellers living in different countries must not only contend with different legal and monetary systems, but must also overcome barriers of time and geography. For example, it often takes twenty to thirty days from the time a U.S. seller delivers goods to an ocean carrier—a shipping line—until those goods arrive overseas. Thus, for twenty to thirty days, neither seller nor buyer has

---

** Associate, Foster, Pepper & Riviera, Seattle, Washington. B.A. 1975, Smith College; J.D. 1978, University of Texas.

physical control of the goods. Who bears the risk during the interval? Having parted with the goods, the seller would like assurances that he will in fact be paid. The buyer, if he is to part with his payment, would like assurances about goods that have not yet arrived. Without some device to deal with these problems, the parties have two choices: the seller can demand cash in advance and put the risk on the buyer; or the buyer can place the risk on the seller through a sale on "open account." In the "open account" situation (e.g. net thirty days or net sixty days from shipment), the buyer will normally see the goods before being required to pay, while the seller, having shipped the goods before payment, is at risk.

Between the two extremes of "cash in advance" and sale on "open account" lie other financing techniques that adjust the risks of seller and buyer. Essential to these techniques is the bill of lading. This document lets the buyer and seller (or their banks) exchange control over the goods for payment while the goods themselves are on the high seas. The bill of lading is a document of title. It represents the goods. The carrier cannot lawfully release the goods without surrender of the bill of lading. In a typical transaction, the bill of lading is passed from the seller to his bank and through banking channels to a bank in buyer's country. The latter bank presents the bill of lading (and often documents) to the buyer in exchange for payment. When the exchange is made, the buyer has legal control over the goods (through the bill of lading) and can procure them from the carrier. As one British court put it, the bill of lading is a "key" which permits the holder "to unlock the door of the warehouse, fixed or floating, in which the goods may chance to be."\(^2\)

Exchange of a bill of lading for payment is central to the export draft and the letter of credit, the two basic financing and payment instruments of international trade. It is at the core of a documentary sale—an exchange of documents including a document of title (the bill of lading) for the buyer's payment.

A. Export Drafts as Collection Instruments

When a New York seller and Hong Kong buyer complete a trade transaction, the actual exchange of documents for payment is usually handled by banks. To carry out the financial end of the transaction, the parties often use an "export draft" or "bill of exchange." An export draft is an unconditional order, drawn by the seller upon the buyer, directing the buyer to pay the face amount of the draft, either when it is presented (a sight draft) or at a specified future date (a time draft or usance). The draft is usually made payable to the order of the seller—or to the order of the seller's bank.

---

1. Collection Process

In the most simple collection, our New York seller will deliver bills of lading, a sight draft and other documents to his bank (the remitting bank). The New York remitting bank will transfer the documents to a correspondent bank in Hong Kong (the presenting or collecting bank), and that bank will present the sight draft and the documents to the buyer. If the buyer honors the draft by paying it, the Hong Kong correspondent will release the documents (including the bill of lading) and wire the proceeds to the remitting bank in New York. A variation on this collection process occurs when the buyer specifies that collection be presented through his bank. In this case, the seller will deliver the documentary draft to a New York branch or correspondent of the buyer's bank. The latter bank becomes the collecting or presenting bank.

2. Collection Instructions

A collection order or collection instruction tells the presenting bank how the collection is to be made: the conditions for delivery of documents, how any dishonor by the buyer is to be handled, how proceeds are to be remitted, and how expenses of the collection are to be borne. The seller usually prepares these instructions. In our example, the New York remitting bank will send the collection instructions, together with the export draft, to the Hong Kong collecting bank.

3. Collection Law

Domestic collections are governed by article 4 of the Uniform Commercial Code (UCC). For international collections of export drafts, banks often incorporate by reference into their collection instructions the "Uniform Rules for Collections" published by the International Chamber of Commerce (ICC). First issued in 1956 and revised in 1978, the ICC Uniform Rules for Collections, when incorporated into a bank's collection instructions, serve as a body of international legal rules that may supplant local law. This incorporation of ICC rules is consistent with banking law in most states. For example, UCC section 1-102(3) states that parties are free to alter, by contract, the rules found in the Uniform Commercial Code—including the rules in article 4 concerning collections.3


4 U.C.C. § 1-102(3) (1978) states that parties are free to alter the Uniform Commercial Code by contract except: (1) where the Code expressly prohibits alteration, and (2) that good faith, diligence, and reasonableness may not be disclaimed. U.C.C. § 4-103(1) (1978) provides that the provisions of article 4 may be varied by agreement except that "no agreement can disclaim a bank's responsibility for its own lack of good faith or failure to exercise ordinary care . . . ."
The Uniform Rules for Collections impose several requirements on a presenting (or collecting) bank. Article 9 requires the presenting bank to tender the documents and draft "without delay." Article 10 requires payment or, if specified, acceptance of the draft by the buyer, before the commercial documents may be released. Under article 15, the presenting bank has the responsibility for determining that an acceptance on a draft is complete and correct, although the bank is not responsible for the authenticity of any signature. If the buyer refuses to pay, article 20 requires the collecting or presenting bank to send an advice of non-payment "without delay." The remitting bank (seller's bank) must then give appropriate instructions on the further handling of the documents.

B. Export Drafts as Flexible Payment Instruments

A time draft gives the buyer additional time to pay. For example, a sixty day time draft—a draft drawn "sixty days from sight"—gives the buyer sixty days to pay after the draft and other documents are presented to him. To receive the bill of lading and other documents, however, the buyer must formally "accept" the draft. This is done by stamping the draft "Accepted" and the buyer signing the draft on its face. Once the buyer "accepts" the time draft, he is committed to pay the draft at its maturity. Under traditional negotiable instruments law, the act of "acceptance" creates an obligation of the buyer on the instrument independent from his duties under the purchase contract. Thus the buyer may become obligated to pay for the goods before he has had an opportunity to inspect them. A time draft, however, has one central benefit for the buyer: It gives him time to resell the goods and use the proceeds to pay his seller when the time draft matures. Thus, when the collection instrument is a time draft, the seller is extending credit to the buyer. If a buyer desires to inspect the goods before making payment, he may try to negotiate payment terms that are either 60, 90, or 120 days "after sight" (after presentation of the draft).

1. Authority to Pay

An export draft can also be structured to speed up payment to the seller. In lieu of the buyer making payment directly to the presenting bank, the buyer could ask his own bank to instruct a correspondent bank in the seller's country to pay the seller. This request is called an "authority to pay" or an "authority to purchase"

5 Uniform Rules, supra note 3, art. 9 (1978).
6 Id. art. 10.
7 Id. art. 15.
8 Id. art. 20.
(depending on how it is structured). It requests a bank in the seller's country—a correspondent of buyer's bank—to pay the seller if the seller presents specified documents. The documents must conform to those mentioned in the "authority to pay." If the documents conform, the bank in the seller's country is authorized to pay the seller.

In our illustration, the buyer's Hong Kong bank would make the request of its correspondent (or branch) bank in New York. The Hong Kong bank will normally have an account in dollars with its New York correspondent. If the New York correspondent bank finds that the documents are conforming, then (a) the seller is immediately paid from the account at the correspondent bank, and (b) the buyer's bank account in Hong Kong is immediately debited. This procedure permits speedy payment to the seller at a relatively low fee to the buyer. However, neither the New York bank nor the Hong Kong bank is obligated to the seller in any way. The buyer, at any time, could ask his bank to cancel the instructions and leave the seller "high and dry."

C. Bank Credit

From the seller's viewpoint, the above situations are dependent on the buyer's credit. A buyer can always decide not to pay a sight draft, not to accept a time draft, or to cancel an authority to pay even though this may put him in breach of the underlying sales contract. Thus, a more reliable alternative for the seller is to have a bank obligated to pay at the outset. A bank's obligation, its promise to pay, is bank credit.

In practice, most international trade finance depends on the extension of bank credit rather than bank loans. The use of bank credit to finance trade is quite different than making a loan. To make a loan, the bank transfers its own funds (from its deposits) to the borrower. With bank credit, the bank does not transfer or lend any funds, but simply lends its own credit, its promise, to finance a transaction. The principal bank credit devices are the letter of credit and the banker's acceptance.

II. Straight Letters of Credit

A. The Basics

A documentary letter of credit is a legal undertaking by a bank to pay a designated "beneficiary" if certain terms and conditions set forth in the letter are satisfied and certain stipulated documents are tendered.¹⁰ For trade transactions, a letter of credit is issued upon

¹⁰ See id. § 5-103. The letter of credit must be in writing and must be signed by the issuer, and any modification thereof must be written and signed by the issuer. A telegram is a sufficient writing for a letter of credit so long as it identifies the seller. Id. § 5-104. No
the application of a bank's customer or "account party" (the buyer/importer). A letter of credit is an obligation from the "issuing bank" to the designated "beneficiary" (the seller/exporter). It finances an underlying trade transaction by assuring the seller/exporter, before parting with his goods, that he will be paid by a bank rather than by a less creditworthy foreign buyer.

A simple letter of credit transaction is illustrated by the following example. A Hong Kong buyer goes to his bank (the "issuing bank") and applies to open a letter of credit in favor of the seller. The buyer (the "account party" or "applicant") will pay a fee and provide appropriate security to support the application. If the letter of credit is issued, the Hong Kong issuing bank will request a bank in the seller's locale (the "advising bank") to advise the seller of the credit. In this way, the seller can assure himself that a satisfactory letter of credit is in place before shipping the goods. After our New York seller ships the goods, he will present the documents to the advising bank in New York. The New York bank, if not authorized to pay under the credit, will transfer the documents to the Hong Kong issuing bank. If the documents conform to the specifications of the letter of credit, the Hong Kong issuing bank will make payment against a sight draft (if a sight draft has been specified in the letter of credit), and wire the funds to New York.

The transaction could work in reverse. For example, in a sale of baseballs from a Japanese exporter to an importer in Seattle, it is the Seattle buyer that would apply to his bank for the letter of credit and enter into the appropriate security agreement. The Japanese exporter, in turn, would present a draft and stipulated documents under the credit. A bank's obligation under a letter of credit is separate and independent from any obligation of its customer to the beneficiary under the sales contract.\(^\text{11}\) It depends only on compliance with the terms and conditions of the credit.\(^\text{12}\) In a documentary letter of credit, the bank's obligation to pay is dependent only upon presentation of drafts and documents which conform to the requirements of the letter of credit.\(^\text{13}\)


1. **Irrevocable vs. Revocable Credits**

Much international trade is financed by irrevocable letters of credit. Once issued, an irrevocable credit cannot be altered, unless, with the beneficiary’s express consent, the account party applies for an amendment. The irrevocable credit gives the beneficiary (seller) certainty of payment if the stipulated documents are presented. By contrast, a “revocable” credit (revocable by the issuing bank) does not give full credit assurance to the seller because it may be rescinded at any time.

2. **Confirmed Credits**

Under a confirmed letter of credit, a second bank (usually in the seller’s locale) has added its credit to that of the initial issuing bank, by confirming that it too will make payment against the specified documents. For example, if our New York bank had not simply advised the seller of the credit, but had added its commitment by confirming the credit, the seller would have two banks assuring payment—both the issuing bank and the confirming New York bank. One advantage in having the New York bank confirm the credit is that a seller is likely to have greater confidence in the credit of a local bank. Additionally, if the seller is worried about possible exchange controls in the buyer’s country, a confirmed credit independently commits a U.S. bank. Often the bank will charge a high fee in this situation, and the buyer and seller will have to decide who is to pay it.

3. **UCC and UCP**

Domestic letters of credit in the United States are generally governed by article 5 of the Uniform Commercial Code. For international letters of credit, most banks incorporate by reference in each of their credit letters an International Chamber of Commerce publication known as the Uniform Customs and Practice for Documentary Credits (UCP). Last revised in 1983, this central body of transnational legal rules effectively provides the “international law” of letters of credit.

4. **Conflicts Between UCP and UCC**

If a bank specifies the UCP in its letter of credit, there are strong

---

14 U.C.C. § 5-106(2) (1978); UCP, supra note 13, art. 10(d); Banco Nacional de Desarrollo v. Mellon Bank, N.A., 726 F.2d 87, 91 (3d Cir. 1984).
15 U.C.C. § 5-106(3) (1978); UCP, supra note 13, art. 9(a). Under the UCP, if a credit does not specify whether it is revocable or irrevocable, it is deemed irrevocable. Id. art. 7(c).
16 U.C.C. § 5-103(f) (1978); UCP, supra note 13, art. 10(b).
17 UCP, supra note 13.
reasons why the UCP rule should prevail over the UCC. First, under the version of UCC section 5-102 adopted in New York, Arizona, Alabama and Missouri, article 5 is rendered inapplicable where a credit is made subject to the UCP.18 In other states, UCC section 1-102(3) gives banks the freedom to "contract out" of article 5 by incorporating the UCP in the letter of credit.19 UCC section 1-102 states: "The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by Agreement . . . ."20 If a bank does not specify the UCP in a credit, the UCP may, nevertheless, be relevant as a "usage" of the banking trade for interpreting that letter of credit.21

B. Time and Place of Payment

Each letter of credit specifies an expiration date and, usually, a place where payment is to be made. The time and place of payment are often critical. To illustrate, assume payment is to be made only at the issuing bank (in buyer’s country) under a credit to expire on October 30. If the exporter presents his documents to the advising bank (in exporter’s country) on October 29, the credit will undoubtedly expire before the documents can be transferred to the issuing bank for payment. Hence, it is always in the exporter’s interest to have the letter of credit specify that the credit is payable "at the counters" of some bank in the exporter’s country, or that it is negotiable "at any bank" before a particular date.22

1. Nominated Bank

A new provision of the 1983 UCP requires all letters of credit to nominate a bank which is authorized to pay or accept drafts under the credit (unless the credit specifies that it is negotiable "at any bank").23 The letter of credit may nominate the issuing bank or a bank in the exporter’s country. The purpose of the new provision is to give the beneficiary clear notice of a bank from which he can expect to obtain payment. UCP article 11 makes clear that nomination by the issuing bank does not create any obligation of the nominated bank to pay under the credit (unless it "confirms" the credit).24 However, if the nominated bank pays against documents which ap-

19 Id. § 1-102(3).
20 Id. § 1-102.
21 Id. § 1-205(2).
22 See UCP, supra note 13, arts. 46-47.
23 Id. art. 11(b).
24 Id. art. 11.
pear on their face to be in accordance with the terms of the credit, the issuing bank is obligated to reimburse the nominated bank.

C. Conformity of Documents

A letter of credit commits a bank's credit only if the terms and conditions of the letter of credit have been satisfied. Demands for payment (i.e., drafts) may not, in the aggregate, exceed the face amount of the letter of credit. Nor may a draft and accompanying documents be presented after the expiration date stated in the letter of credit. Most importantly, there must be compliance in furnishing the precise documents specified in the letter of credit.

1. Strict Compliance Rule

The classic expression of the strict compliance rule for documents presented under a letter of credit originates from an English decision: "There is no room for documents which are almost the same, or which will do just as well."

Strong policies support a strict compliance rule. Certainty and reliability of the bank's credit is foremost: All parties should be certain that if the documents conform, the bank will pay, while if they do not conform, the bank will dishonor. There is also a policy of equity: in exchange for the certainty of payment to the beneficiary (seller), the account party (buyer) is entitled to the certainty that the documents he receives will be precisely those specified in the credit. The buyer is relying on the bank to use reasonable care to detect any defects in the documents. Finally, there is a policy of efficiency: bank employees can quickly determine if all documents match the specifications in the credit. In contrast, if banks were obligated to ascertain whether seemingly minor discrepancies were important or not, credits would be more costly and banks would have a greater risk of liability to the account party (buyer) who might take a different view of the bank's judgment.

When there is a substantial discrepancy in the documents, U.S. court decisions have upheld the strict conformity rule. For example, when a credit specified "on board" bills of lading (signifying

25 Equitable Trust Co. v. Dawson Partners, [1927] 27 Lloyd's Rep. 49, 52. The court continued:

The bank's branch abroad, which knows nothing officially of the details of the transactions just financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk.

Id.

26 See Marino Indus. v. Chase Manhattan Bank, N.A., 686 F.2d 112, 115 (2d Cir. 1982); see also Mount Prospect, 121 Ill. App. 3d at 295, 459 N.E.2d at 979.

ocean shipment) but the beneficiary decided to ship by air and presented airway bills, the bank was entitled to dishonor. In another case, a letter of credit specified presentation of certificates of inspection and bills of lading, evidencing shipment by January 31. Although the bills of lading presented to the bank were dated January 31, the certificates of inspection said the goods had been inspected (prior to loading) on February 6. The confirming bank dishonored the draft, and the district court held that the dishonor was justified.

Both the UCC and the UCP support the rule of strict compliance. The UCC specifies that the bank's duty is to examine documents to see that they comply on their face with the credit, and the bank is not charged with responsibility based on knowledge or lack of knowledge of any usage of particular trade. The 1983 version of the UCP states that the duty of the bank is to examine documents "with reasonable care" to ascertain if they comply "on their face" with the letter of credit.

2. Substantial Compliance

Some U.S. courts have abandoned strict conformity for a "substantial compliance" rule. The cases applying this less strict doctrine usually involve minor discrepancies in the documents and a concern by the court that a bank may be using a minor discrepancy to permit its customer (the buyer) to extricate himself from the underlying transaction. An early example is Banco Espanol de Credito v. State Street Bank & Trust Co. in which a letter of credit required a certificate stating that "the goods are in conformity with the order." The beneficiary supplied a certificate stating that based on a ten percent sample, the goods were "found conforming to the conditions stipulated on the order-stock-sheets." The court ruled that even this grossly divergent certificate substantially conformed and dishonor was improper.

A more defensible result was reached in Flagship Cruises, Ltd. v. New England Merchants National Bank. The credit at issue required presentation of a written statement that the accompanying "draft" related to a certain agreement. The statement, however, said that

---

28 Board of Trade of San Francisco v. Swiss Credit Bank, 728 F.2d 1241, 1243 (9th Cir. 1984).
29 Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, N.A., 545 F. Supp. 301 (S.D.N.Y. 1982), remanded, 707 F.2d 680 (2d Cir. 1983). Note that UCP, supra note 13, art. 15 says that documents "inconsistent with one another" are nonconforming.
32 UCP, supra note 13, arts. 15, 16(b).
34 Id. at 233.
35 569 F.2d 699 (1st Cir. 1978).
the "letter of credit" related to the agreement. Nevertheless, the court ruled that there was substantial compliance.\textsuperscript{36}

Such decisions, however, place a bank in the position of judging the significance of discrepancies. Beneficiaries under letters of credit, as professional merchants, should be held to submitting precisely what the credit calls for. Alternatively, the beneficiary could present documents sufficiently ahead of the credit's expiration date to permit a cure of any document deficiencies, or request the buyer to apply for an amendment to the letter of credit.

A problem related to the "substantial compliance" doctrine arises when there are ambiguities in a letter of credit. The courts usually respond by applying the familiar contract law principle that ambiguities are construed against the author of the document. In \textit{Marino Industries v. Chase Manhattan Bank, N.A.}\textsuperscript{37} a German bank issued a letter of credit which was confirmed by Chase Manhattan. In its confirmation to the beneficiary (Marino), Chase advised that the documents had to include a signed \textit{certificate} by a representative of a Saudi joint venture (called Mdica). Later, the issuing bank in Germany, Berliner Bank, furnished Chase with samples of three signatures of representatives of the Mdica joint venture, and instructed that the certificate had to bear one of these three signatures. Marino presented a certificate that had a different signature. Chase refused to pay. The court of appeals stated:

As we have noted, an important corollary of the strict compliance rule is that the letter of credit must specify precisely and clearly the requirements for payment, and ambiguities in the letter are to be resolved against the bank. Nothing in the letter in this case indicated that the requirement that the certificates be "signed by [a] Mdica representative" be satisfied only if the three acceptable signatures that Berliner Bank had submitted Chase were affixed. If that was a condition of payment, Chase was required so to inform Marino.\textsuperscript{38}

\section*{D. Custom, Indemnities, Amendments and Estoppel}

It is fundamental that the letter of credit is separate and independent from the underlying sales contract between the buyer/account party and the seller/beneficiary. If a beneficiary presents documents which are nonconforming under the credit but meet his obligations under his sales contract with the buyer, it is to no avail. Under the strict conformity rule, bankers are not to be held responsible for judging documents against the underlying sales contract, or against trade custom.

In a case involving a letter of credit confirmed by Chase Manhat-

\textsuperscript{36} \textit{Id.} at 704.
\textsuperscript{37} 686 F.2d 112 (2d Cir. 1982).
\textsuperscript{38} \textit{Id.} at 117.
tan Bank, the credit required the presentation of a certificate stating that freight charges had been "prepaid." The certificate that was presented contained no such statement. It did, however, have a box at the top containing the word "cash" which was crossed out. The beneficiary presented evidence of a trade custom that, when the word "cash" was crossed out on such a certificate, it meant that freight charges had been prepaid. The beneficiary claimed that since this was a trade custom involving documents, the banks should be obligated to adhere to this custom. The court disagreed, ruling that banks were not bound to follow customs in other trades.

1. Indemnities

If a document has a discrepancy, what is the beneficiary to do? The seller may offer to indemnify (or guarantee) the issuing bank against the risk that the documents will be rejected by the buyer/account party. If the buyer rejects the documents, the seller must return any payment he received as well as compensate the bank for any other losses. It is up to the seller/beneficiary to decide whether to offer an indemnity—and up to the bank whether to accept an indemnity. A famous and controversial case, however, held that a bank may have to accept an indemnity, at least where local bank custom so requires.

2. Amendments

The exporter confronted with a nonconforming document has another option. Instead of offering to indemnify a bank—a risky undertaking—the exporter can ask his importer to secure an amendment to the letter of credit. For example, if the document shows that the goods were received by the carrier on July 1, but the credit calls for "June shipment," the exporter can try to persuade the importer to have the credit amended to allow July shipment as well. The exporter may have to give his buyer some concession, unless the underlying sales obligated the buyer to amend the letter of credit in these circumstances.

The careful exporter may insist, in his underlying sales contract, that his buyer, on request, obtain reasonable amendments to letters of credit. Note that any amendment must be approved by all of the

---

39 Id. at 119.
40 Id. at 119-20. J. H. Rayner, 1 K.B. at 36. Some courts have held that "custom" and "usage" affect interpretation of letter of credit provisions but cannot be used to alter or add to the letter of credit unless the letter expressly incorporates "custom" and "usage" in its terms. Bank of Canton, Ltd. v. Republic Nat'l Bank of N.Y., 509 F. Supp. 1310 (S.D.N.Y.), aff'd, 636 F.2d 30 (2d Cir. 1980).
41 See Dixon, Irmaos & Cia, Ltd. v. Chase Nat'l Bank, 144 F.2d 759 (2d Cir.), cert. denied, 324 U.S. 850 (1944) (banks can be held to observe "bank custom" as opposed to the custom of a particular trade).
parties involved: the account party (the bank), the beneficiary (the exporter), and the issuing bank. If a letter of credit has been confirmed, in addition to the cost and delay, there is the requirement that the confirming bank give its approval as well.

3. Estoppel

The 1984 UCP requires an issuing bank to specify without delay "the discrepancies in respect of which the issuing bank refuses the documents."[42] If an issuing bank fails to so specify without delay, "the issuing bank shall be precluded from claiming that the documents are not in accordance with the terms and conditions of the credit."[43] The purpose of this rule is to give the beneficiary an opportunity to cure any document defects before the letter of credit expires. If the issuing bank delays, it is estopped from asserting any nonconformity and is liable on the credit. If it specifies certain discrepancies which are then cured, the issuing bank is estopped from asserting any other pre-existing discrepancies.

A crucial question is what constitutes "delay." Once a beneficiary (seller) presents documents under a letter of credit, how much time does an issuing or confirming bank have to review the documents and either dishonor or pay the drafts? The UCC specifies that the bank should be given three days. The UCP states a "reasonable period," which suggests more than three days. The issue is important to the beneficiary (seller), because if the documents and drafts are dishonored, the seller will want enough time to cure the documents before the letter of credit expires. At least one court has said that several days is reasonable under the UCP. The indefiniteness of the UCP rule leaves the seller (beneficiary) with the uncertainty of not knowing how long it has to cure a document defect before the credit expires.

E. Document Interpretation Rules

The UCP has interpretive provisions for ascertaining whether documents conform to the credit. For example, the description of the goods in the commercial invoice must correspond exactly to the description in the credit. The description of the goods in other documents (e.g., the bill of lading) may be general in its terms so long as

[42] UCP, supra note 13, art. 16(d).
[43] Id., art. 16(e).
[45] UCP, supra note 13, art. 16(c).

Waiver is similar to estoppel, except that it involves some affirmative action by an issuing or confirming bank which conveys to the beneficiary that it will pay on documents despite possible non-conformities. See Voest-Alpine, 707 F.2d at 680.
the documents are "not inconsistent." Suppose, for example, a letter of credit covers a shipment of "Sony Model KV-100 Television Sets." If the exporter's invoice states precisely these words while the bill of lading or insurance certificate says only "Sony TV's," both descriptions should be acceptable. If, however, the exporter's commercial invoice only said "Sony TV's," the documents would be nonconforming.

1. Bills of Lading

There may be clauses on a bill of lading that will automatically make them nonconforming under a letter of credit. Article 34(a) of the UCP states: "A clean transport document is one which bears no superimposed clause or notation which expressly declares a defective condition of the goods and/or the packaging." Thus, any bill of lading which has a "superimposed clause" that "expressly declares a defective condition" in the goods or packaging, cannot qualify as a "clean" bill of lading. Banks are directed to reject documents which bear such superimposed clauses or notations.

Another requirement for a standard marine bill of lading is that the bill indicate that the goods have been loaded "on board" a vessel. Under the UCP, only such "on board" bills of lading are to be accepted by banks under a letter of credit.

2. Other Transport Documents

The 1983 UCP made important changes in the interpretive rules for documents covering transport of cargo. Under traditional practice, the marine bill of lading was regarded as the central transport document. The UCP still permits the applicant (buyer) to protect himself by specifying a marine bill of lading in the letter of credit. In all other cases, the UCP acknowledges the changes in documents necessitated by containerized transport. Thus, a transport document will be deemed conforming if it simply: (i) indicates that it has been issued by a named carrier or his agent; (ii) indicates that the carrier has either dispatched, taken charge of, or loaded the goods; (iii) consists of the full set of originals; and (iv) otherwise complies with the credit. The UCP also requires that a transport document be presented within twenty-one days after it was issued unless some other period is stipulated. Also, the transport document must appear to cover the entire voyage, no matter how many modes of trans-

47 UCP, supra note 13, art. 41(c).
48 Id. art. 34(a).
49 Id. art. 34(b).
50 Id. art. 26.
51 Id. art. 25(a).
52 Id. arts. 24, 47(a).
port are used. If these conditions are not met, the transport
document is to be rejected.

The foregoing discussion has analyzed straight credits, which
are available from an issuing or confirming bank upon presentation
of a sight draft and conforming documents. The seller (beneficiary)
presents the conforming documents and a sight draft, and is paid
either by the issuing bank (or confirming bank), or by another bank
ominated to pay under the credit. When a separate bank nomi-
nated for payment pays under the credit, the issuing bank is obli-
gated to reimburse it, provided the documents conform to the
credit.

III. Special Letters of Credit

A. Negotiable Credits

Another type of letter of credit is a negotiable credit, which per-
mits drafts to be “negotiated” at any bank. Although no bank (other
than the issuing bank) is obligated to pay drafts drawn under such a
letter of credit, if a bank does pay (i.e., “negotiates” drafts drawn
under the credit), the bank is entitled to reimbursement.

The reimbursement may come from either of two sources. The
first is the issuing bank itself. The second is the “reimbursing
bank,” a third bank named in the letter of credit as authorized to
reimburse the “negotiating bank.” The reimbursing bank is usually
a correspondent of the issuing bank located in the seller’s country.
The bank that negotiates a draft under the credit (the negotiating
bank) thus has the additional assurance of another bank in the same
country which is committed to pay under the credit.

To illustrate this reimbursement concept, assume buyer’s bank
in Japan, Bank B, issues a negotiable letter of credit (drafts that may
be negotiated “at any bank”). The credit names Bank B’s correspon-
dent in Los Angeles, Bank R, to be the reimbursing bank. A seller in
Denver (after he ships the goods) approaches his local Denver bank,
Bank S, and tries to persuade Bank S to take the documents and pay
against a draft drawn on Bank B under the credit. If Bank S chooses
to pay the draft, it could receive reimbursement by presenting the
draft (and documents) to either Bank R in Los Angeles or Bank B in
Japan. In practice, Bank R is not only a correspondent of Bank B in
Japan, but may also be a correspondent of Bank S in Denver.

Negotiable letters of credit enable sellers outside main commer-
cial banking centers to deal with their own local banks in interna-
tional transactions. Another advantage of negotiable letters of

53 Id. art. 29(b).
54 Id. art. 11(d).
55 See id.
credit, issued in a foreign currency, is that they permit the seller to shop around for advantageous foreign exchange rates. For example, if the credit is in Japanese yen, the beneficiary can try to negotiate a yen draft under the credit with whatever bank would offer the most dollars for that draft.

B. Transfer of a Credit; Financing the Exporter

In addition to financing the immediate transactions between the exporter and importer, letters of credit can finance trade in other ways. The exporter will frequently have to purchase goods or raw materials from another supplier. Often, the seller will prefer not to pay his supplier until he has been paid by the foreign buyer. A letter of credit can be adapted to enable the exporter to finance purchases from his supplier.

1. Back to Back Credits

Once the foreign buyer's bank has issued an initial letter of credit, an exporter may ask the advising bank (or other bank) to issue a second letter in favor of the exporter's supplier. The advising bank might be induced to do this if the terms of the second letter of credit were to be nearly identical to those of the first, and if the bank believed that after the supplier presented documents under the second letter, the bank would then have the documents needed under the first letter.

Assume, for example, that an exporter in Seattle has agreed to sell apples to a buyer in Taiwan, terms “FOB vessel Seattle.” The buyer's bank in Taiwan, Bank B, issues a letter of credit in favor of the exporter which is advised by Bank S in Seattle, and is also nominated for payment. The exporter, however, has to purchase the apples from a cooperative in Spokane. To finance that purchase, he might ask Bank S to issue a second letter of credit in favor of the cooperative. Bank S, before issuing the credit, will want to know if the cooperative will sell to the exporter also on terms “FOB vessel Seattle.” If so, Bank S would be assured of having the documents it could use with Bank B under the first letter of credit. If not, Bank S would want assurance that the exporter will obtain the precise documents required under the first credit.

2. Transferable Credits

A back to back credit is somewhat burdensome and expensive. A more direct approach is for our exporter in Seattle to persuade his Japanese buyer to have Bank B in Japan issue a “transferable letter of credit.” Once issued, this permits our exporter in Seattle to transfer to a third party (e.g., the cooperative in Spokane) the right to draw under the credit, provided the letter of credit expressly permits the
In this situation, the exporter is called the “first beneficiary” and the cooperative the “second beneficiary.”

The cooperative must present the precise documents required by Bank B in Japan under the letter of credit. If the terms of the transaction covered by that letter of credit were, for example, “FOB vessel Seattle,” the cooperative would be responsible for shipping the goods overland to Seattle and obtaining a bill of lading and other documents called for under the credit. The inland cooperative may not want to do this. In that case, the parties should consider either a back to back credit or an assignment of proceeds.

3. Assignment of Proceeds

An assignment of proceeds is an agreement between the beneficiary of a letter of credit (e.g., the exporter) and the bank nominated to make payment that, upon presentation of conforming documents by the exporter, the proceeds will be paid to a third party. That third party is typically a supplier of the exporter (such as our cooperative from Spokane). Under our example, the cooperative would have some security because, once the assignment of proceeds is made, it cannot be revoked. The cooperative knows it will receive the proceeds, provided the exporter goes ahead with the shipment and complies with the letter of credit. However, if the exporter does not make shipment or does not present conforming documents under the credit, the assignment becomes worthless and the supplier is left empty handed.

C. Deferred Payment Credits; Financing the Importer

The buyer (or importer) in the foreign country may need time to finance his purchase from the exporter. Time is valuable to the importer because it allows him to resell the goods and use the proceeds to finance the import transaction. A letter of credit can be structured to give the buyer additional time.

1. Time Draft Letter of Credits

Most letters of credit provide for payment against sight drafts presented by the beneficiary. However, the importer seeking additional time can negotiate with his exporter for payment against time drafts. When the letter of credit provides for payment against a draft that is “90 days from sight” or “90 days from bill of lading date,” the bank paying under the letter of credit will simply “accept” the drafts presented by the beneficiary. It will then pay those drafts when they mature in 90 days.

56 U.C.C. § 5-116(1) (1978); UCP, supra note 13, art. 54(b).
2. Deferred Payment Letters of Credit

Another way to buy time for the importer (to permit him to acquire proceeds on resale to pay the exporter) is through a “deferred payment letter of credit.” It differs from a “time draft” letter of credit in one key respect. Instead of the exporter presenting a time draft with his other documents, the exporter presents the documents, waits a specified time, and then presents a sight draft. The intervening time permits the buyer to deal in the goods before payment is required.

D. Standby Letters of Credit

Occasionally the buyer will want greater certainty concerning the seller’s delivery of the underlying goods. This can occur, for example, where the seller is to provide machinery or equipment for the buyer’s plant. A buyer requiring prompt delivery (to meet construction timetables) and full conformity to specifications may demand a guarantee of the seller’s performance in the form of a “standby letter of credit.”

Under a standby credit, the seller is the “account party” who applies for the credit. It is the seller’s bank that issues the credit while the buyer becomes the beneficiary. Frequently, the only document required under a standby letter is a certification from the buyer (or his architect-engineer) that the seller has not performed. The certificate may be a single sentence. If the simple certificate conforms to what the letter of credit specifies, the issuing bank will be obligated to pay. Because of the ease with which a certificate can be prepared, standby letters have sometimes generated claims that the certification is fraudulent and, therefore, payment should be stopped.57 Cases involving the Iranian Revolution illustrate the problem.58 Consequently, recent commentators have suggested that those applying to banks for the issuance of standby letters of credit would be well advised to take several precautionary steps: 1) Avoid the bare suicide standby letter of credit payable on simple demand and insist on detailed documentary requirements and conditions requiring specific factual representations. 2) Require that any certificate come from an independent third party. 3) Have the standby letter of credit reduced upon documentation of the account party’s partial performance. The account party should have the right to submit this documentation. 4) Have the underlying contract provide for release of letters of credit or other performance guarantees upon

cancellation of the contract for any reason. 5) Require the benefici-
ary to present any certificate of default first to the account party,
before making any demand under the standby letter of credit—in or-
der to give the account party a few days to discover any fraud or to
seek an injunction.59

IV. Fraud: Stopping Payment Under Letters of Credit

Fraud poses a difficult problem under letter of credit law be-
cause it undermines the certainty and reliability of a bank credit.
Courts have stopped payment in certain cases when fraud has been
present. The justification is that the conduct of the beneficiary is so
outrageous, so contrary to the public policy, that the law should not
be applied to further the fraud. Before choosing between competing
policy goals—enhancing the reliability of letters of credit versus
preventing unjust enrichment from a fraud—the different situations
in which claims of fraud may be made should be considered.

A. Fraudulent Documents and Fraud in the Transaction

Letters of credit are based on conformity of documents. A
forged bill of lading, by definition, does not conform to the credit. A
letter of credit implicitly calls for genuine, not forged documents. A
more difficult situation arises when the document is genuine, but is
part of a fraud. For example, an exporter (who is a beneficiary under
a letter of credit) delivers sealed boxes to a carrier and says they con-
tain high-fashion sweaters. In exchange, the carrier issues a bill of
lading for boxes “said to contain” sweaters. Actually, the exporter
has filled the boxes with shredded newspapers. The bill of lading is
genuine, and it conforms “on its face” with the terms of the letter of
credit. The traditional rule is that the bank is not supposed to look
beyond the documents to the underlying transaction. Indeed, a bank
is normally precluded from doing so.60 Yet, the courts have felt un-
comfortable about allowing a bank to become an accessory to a fraud
when the bank’s customer (the buyer of the goods) learns of the
fraud before the bank has paid under the credit.

The seminal case on this type of fraud is Sztejn v. J. Henry Schroder
Banking Corp.61 There, the buyer (and bank customer) discovered a
fraud and brought an action to enjoin payment under the letter of
credit. The alleged fraud was that shredded newspapers had been
substituted for a shipment of bristles. The issue was presented on a
motion to dismiss. Thus, the court was asked to decide whether the
bank’s customer had a cause of action to enjoin payment under a
letter of credit on grounds of fraud. In response, the court distin-

59 Kimball & Sanders, supra note 1, at 437-39.
60 See Maurice O’Meara, 239 N.Y. at 386, 146 N.E. at 636.
guished this case from a normal commercial dispute regarding goods: "This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer." The court concluded that when there has been a total failure of performance by the seller, the buyer has a cause of action to enjoin the bank from making payment under the letter of credit:

No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, where the draft and the accompanying documents are in the hands of one who stands in the same position as the fraudulent seller, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment, and where the bank itself does not wish to pay pending an adjudication of the rights and obligations of the other parties.63

The "worthless rubbish" test in Stzejn has since been refined. In a recent case involving a standby letter of credit, a court stated that the issue was whether the beneficiary has any "plausible or colorable basis" under the underlying contract to call for payment under a letter of credit.64 Under this test, the goods may not actually be worthless; they only need to be so non-conforming that the seller has no plausible or colorable basis to claim that he has performed the contract.65

The rules specifying when a bank may be prevented from paying under a letter of credit are codified in the UCC. After first stating the basic proposition that drafts should be honored when documents comply on their face with the credit, UCC section 5-114(2) permits a bank to dishonor a draft when a document does not conform to warranties implied by law;66 when a document is "forged"; when a docu-

---

62 Id. at 721-22, 31 N.Y.S.2d at 634.
63 Id. at 723, 31 N.Y.S.2d at 635.
64 Itek Corp., 730 F.2d at 19.
65 See United City Merchants, [1982] 2 Lloyd's Rep. at 1; Edward Owen Eng'g's, Ltd. v. Barclays Bank Int'l Ltd., [1978] 1 Lloyd's Rep. 166, which discuss fraud as an exception to the bank's duty under a letter of credit. The House of Lords in United City Merchants said that to vitiate the payments or permit a bank to dishonor a letter of credit, the seller/beneficiary must have knowledge of the existence of the fraud or inaccuracy. In United City Merchants certain brokers acted fraudulently in issuing a bill of lading. The seller (the beneficiary of credit) did not know of the fraud. According to the House of Lords, the "innocent" seller was entitled to payment under the letter of credit. United City Merchants, [1982] 2 Lloyd's Rep. at 6-7. See also KMW Int'l v. Chase Manhattan Bank, 606 F.2d 10 (2d Cir. 1979); Cromwell v. Commerce & Energy Bank, 464 So. 2d 721 (La. 1985); Fertigo Belgium S.A. v. Phosphate Chem. Export Ass'n, 100 A.D.2d 165, 473 N.Y.S.2d 403 (1984); Foreign Venture Ltd. v. Chemical Bank, 59 A.D.2d 352, 399 N.Y.S.2d 114 (1977); Intra World Indus. v. Girard Trust Bank, 461 Pa. 943, 336 A.2d 316 (1975).
66 For example, U.C.C. § 7-507 implies a warranty on the transfer of a bill of lading that is genuine and covers what it purports to cover. If the bill of lading has been forged or doctored, this warranty is breached and a bank may refuse to pay under a letter of credit. U.C.C. § 7-507 (1978).
ment is "fraudulent"; and most serious, when there has been "fraud in the transaction."\textsuperscript{67}

These reasons for stopping payment under a letter of credit are subject to three important caveats. First, UCC section 5-114(2)(b) gives a bank an option: even if a bank has notice of a fraud, it still has the right to pay under the letter of credit if the documents on their face are conforming.\textsuperscript{68} Article 17 of the UCP similarly provides that banks have no liability if they pay against conforming documents, even when there is an underlying fraud.\textsuperscript{69}

The second caveat relates to who presents the drafts and documents under a letter of credit. If that person is a holder in due course (a person who purchased the documents for value and without notice of the fraud) the issuing bank "must honor the draft or demand for payment."\textsuperscript{70} However, once it is shown that a fraud has occurred, a person claiming to be a holder in due course may have the burden of proving his status as such.\textsuperscript{71}

The third caveat relates to the legal process by which a bank customer asks a court to stop payment under a letter of credit. It involves legal principles applicable to the law of injunctions and attachments.

\textbf{B. Stopping Payment by Way of Injunction or Attachment}

There are two ways to stop payment under a letter of credit. One can try to enjoin a bank from honoring drafts drawn under the credit. Or, if drafts have been "accepted" but not yet paid, one can try to attach the proceeds before they are paid.

When an account party seeks to stop payment, it usually brings an injunction action against the bank. A basic injunction requirement under U.S. law is a showing of "irreparable harm," or that there is no adequate remedy at law. These requirements can present formidable hurdles to obtaining an injunction to stop payment. If the bank is allowed to pay under the letter of credit, the buyer would simply be out money. He would then have a remedy at law; a damage action against the beneficiary (seller) to recover the money. The fact that the buyer must sue in the seller's jurisdiction is precisely what the buyer bargained for when he applied for the letter of credit. One consequence of the letter of credit is to shift the burden of litigation to the account party once conforming documents are

\begin{itemize}
  \item \textsuperscript{67} Id. § 5-114(2).
  \item Id. § 5-114(2)(b).
  \item Id. § 5-114(2)(b).
\end{itemize}
presented. Some courts have held that unless the courts in the beneficiary's country are not adequately functioning (such as occurred in Iran), the account party has a remedy at law and an injunction against the bank should be denied.  

Conversely, to establish irreparable harm, the party seeking to enjoin payment must show that, if payment under the letter of credit were allowed, there would be no practical vehicle to recover the money in a subsequent lawsuit (or arbitration).  

An account party may, alternatively, seek to attach funds at a bank intended to be paid under a letter of credit to a defrauding exporter. This situation arises when drafts under a letter of credit have been "accepted," but not yet paid. An attachment is normally available only to a party seeking a money judgment with respect to an obligation owed to him. An account party, however, is technically not a party to the letter of credit and certainly has no obligation owing to him under it. The obligation is to the beneficiary. (The account party's relationship with the bank is based on the letter of credit application and any related security agreement). U.S. courts have usually adhered to this view. Moreover, the sanctity of a bank's obligation to pay, at maturity, a draft it has previously accepted has been relied on to preclude an attachment or injunction that would otherwise preempt that obligation.

V. Financing with Banker's Acceptances

A. Trade Acceptances

A buyer's "acceptance" of a time draft obligates him to pay the instrument at maturity. A draft accepted by a commercial party (like the buyer or importer) is known as a "trade acceptance." A person holding a trade acceptance (the exporter or his bank) has two choices. He can wait until the acceptance matures, and then be paid

---

72 See KMW, 606 F.2d at 10; American Bell Int'l, 474 F. Supp. at 420 (held that Bell entered deal with its "corporate eyes open" and that Bell would only suffer money damages if an injunction was not issued). Some courts, however, have deviated from these injunction standards. See, e.g., Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973).


75 First Commercial Bank, 64 N.Y.2d at 297, 475 N.E.2d at 1260, 486 N.Y.S.2d at 720.

76 U.C.C. §§ 3-410, 3-413 (1978).
Discounting an accepted draft—or an “acceptance”—is a method of financing that allows the holder of the draft to exchange it at a discount for immediate funds. For example, if buyer accepts a ninety day time draft for 10,000 dollars, the seller may try to sell the acceptance at a discount (e.g., for 9,750 dollars) so he can be paid at once. The exporter may ask his own bank (or a collecting bank) to discount a draft accepted by his buyer. Normally, however, the seller cannot sell the acceptance (or discount it) to a third party, because the buyer does not have acceptable credit. An exception is a draft accepted by a major corporation such as General Motors or IBM. To the extent an acceptance can be marketed (or sold at a discount), it provides a financing vehicle for the seller. It gives him payment (less a discount) before the acceptance matures. The time draft also finances the buyer (until the acceptance matures) by giving him time to resell the goods and to use the proceeds to repay his seller.

B. The Banker’s Acceptance

If a bank accepts a draft drawn on it, the bank has lent its own credit to the instrument and is obligated to pay the draft at maturity. This form of bank credit is called a “banker’s acceptance.” It constitutes an irrevocable primary obligation of the accepting bank. This obligation, which arises from the bank’s act of accepting a draft, may occur as part of a letter of credit transaction, or independently. The act of acceptance creates an irrevocable primary obligation that is separate from any underlying sales contract, or from any related letter of credit obligation.

A banker’s acceptance bearing the credit of a major bank is clearly marketable. As a trade financing device, a banker’s acceptance (unlike the letter of credit) is usually not transferred across national boundaries.

The following hypothetical illustrates how a banker’s acceptance works. Assume a New York exporter needs financing to manufacture goods which he will ultimately export to Hong Kong. The exporter could enter into an acceptance credit agreement with his local bank (Bank A), under which Bank A agrees to accept drafts to be drawn by the exporter on the bank. He pays the bank a commission or application fee. Next, the exporter draws a 10,000 dollar ninety day time draft (e.g., payable ninety days from acceptance) on Bank A. The bank accepts the draft by stamping “Accepted” and then dating and signing the draft on its face. Next, the exporter (in his role as payee of the draft) may negotiate the instrument by endorsing it and deliv-

---

77 See id. §§ 3-413, 4-303.
erating it back to Bank A, in return for a discounted payment (e.g., 9,750 dollars). Our exporter now has money (9,750 dollars) to finance manufacture of the goods and Bank A (as endorsee) is now a "holder" of the 10,000 dollar draft it previously accepted.

Our New York bank, Bank A, then has two choices. First, it can hold the draft until maturity and then demand repayment from the exporter. Under this scenario, however, Bank A will be out of funds until the draft matures, and the acceptance will be similar to an ordinary loan. The second and more normal scenario is for Bank A to immediately rediscount the acceptance to another bank. It does this by negotiating the draft (by endorsement and delivery) to a second bank (Bank B) and receiving in return the face amount of the draft reduced by an agreed "rediscount rate." Now, Bank A has financed its customer, and because it has been paid by Bank B, it is not out any funds. Indeed, by setting the original discount rate to its customer lower than the rediscount rate, Bank A has made a slight profit. For example, on rediscounting the acceptance, Bank A may be paid 9,800 dollars, fifty dollars more than it paid to our exporter.

When the accepted 10,000 dollar draft finally matures (ninety days hence, in our example), the exporter will hopefully have sold his goods, received payment and repaid 10,000 dollars to Bank A. The latter will have the funds on hand (the 10,000 dollars from the exporter) to meet its obligation on the acceptance. Bank B (the rediscounting bank) will then present the acceptance to Bank A for payment of 10,000 dollars. Bank A, having originally accepted the draft, has an absolute obligation to pay at that time. At the end of the day, Bank A will not have used any of its own funds, only its credit, and will have made a profit on both the rediscount and the application fee.

The Hong Kong importer can do the same thing with his bank. By discounting a banker's acceptance with his Hong Kong bank, the importer can finance its payment to the New York exporter and the Hong Kong bank will be repaid after the importer resells the goods to a third party in Hong Kong.

C. Eligible Banker's Acceptances

In addition to avoiding direct use of their own funds, national banks and state member banks of the U.S. Federal Reserve System can obtain an additional advantage for financing trade with "acceptance credit": if a banker's acceptance meets certain "eligibility requirements," the bank may make and rediscount acceptances.

78 The eligibility requirements for bankers' acceptances appear in § 13(7) of the Federal Reserve Act. 12 U.S.C. § 372 (1982). They are referred to as eligibility requirements because, if satisfied, the acceptance is "eligible" for discount by any Federal Reserve Bank (although in practice this rarely, if ever, occurs).
without regard to reserve requirements. Normally, bank deposits are subject to reserve requirements under the Federal Reserve System’s Regulation D, which limits the lending ability (and hence potential credit to be lent) by most U.S. banks. Eligible banker’s acceptances, however, are not limited by deposits or reserves. Thus, a bank can often have more “credit” outstanding by way of eligible banker’s acceptances than it can through ordinary loans.

An eligible acceptance must grow out of one of four types of transactions: a transaction involving the importation or exportation of goods; a transaction involving the domestic shipment of goods; acceptances secured by documents conveying title to readily marketable staples; and certain foreign exchange transactions.79

In addition to stamping an “Acceptance” on the face of a draft, an accepting bank seeking an eligible acceptance must also stamp on the face a legend, known as an “eligibility certificate.” For import-export transactions, the eligibility certificate will state the nature of the transaction (import or export), the product or commodity being shipped, the countries of shipment and destination, and the name of the accepting bank.80

Finally, eligible acceptances must also originate from transactions “having not more than six months sight to run.”81 To fulfill this requirement, two conditions must be met. The first is that the draft must not mature more than six months after its acceptance. The second involves a policy decision that acceptances should be self-liquidating: the underlying transaction should produce the funds in time to pay off the acceptance.82 Accordingly, if the buyer is obligated to pay on the underlying transaction within ninety days, the eligible acceptance should mature at the end of those ninety days and not later.83

Eligible acceptances, again, are exempt from reserve requirements. However, total outstanding eligible acceptances growing out of import or export transactions may not exceed 150 percent of the capital stock and surplus of the bank.84 (With the authorization of the Federal Reserve Board, this may be increased to 200 percent of capital and surplus).85 Also, outstanding acceptances to any one person or entity may not exceed ten percent of the bank’s capital and surplus.86 Ineligible acceptances are not subject to these capital requirements, but they are treated as “deposits” subject to the Regula-

---

79 Id. § 372(a).
80 1928 F.R. Bulletin 517.
82 1921 F.R. Bulletin 70.
85 Id. § 372(c).
86 Id. § 372(e).
tion D reserve requirements.\textsuperscript{87}

The net effect of an "eligible" banker's acceptance is to create additional credit to finance trade, unfettered by the reserve requirements that apply to ordinary bank loans. Because this may be cheap credit for a bank, the discount rates charged to an exporter or importer may result in a lower financing cost than would the interest charges on a loan, while at the same time providing a secure source of financing.\textsuperscript{88}

VI. Conclusion

As this article has suggested, there are numerous ways a buyer and seller can finance an international trade transaction. Before choosing any particular approach, it is important for the parties to appreciate the benefits and risks of each. One should also appreciate that there are other methods to finance trade. Government institutions, like the Export-Import Bank of the United States (EX-IMBANK), offer a number of programs that either finance transactions or that provide insurance against the risk of nonpayment. The buyer and seller themselves may also resort to countertrade, barter agreements or toll processing arrangements to finance the relationship between them. It is essential that the lawyer practicing in the international trade area have a basic grasp of each of these mechanisms.

\textsuperscript{87} 12 C.F.R. § 204.2(a)(1)(vii)(E), and (viii) (1985).

\textsuperscript{88} In a recent case, a bank issued a letter of credit, accepted drafts drawn under the letter, and was subsequently served with a restraining order prohibiting it from paying on the letter of credit because of "fraud in the transaction." First Commercial Bank, 64 N.Y.2d at 292-95, 475 N.E.2d at 1257-58, 486 N.Y.S.2d at 717-18. The court held that the act of acceptance made the bank unconditionally obligated to pay the drafts upon maturity, and because the restraining order was served after the bank's acceptance of the drafts, it came too late to prevent payment on the drafts. The court stated that enjoining banks from paying drafts they had previously accepted would seriously undermine the banker's acceptance market and hinder the use of bankers' acceptance as a financing tool. Id. at 298, 475 N.E.2d at 1261, 486 N.Y.S.2d at 721.