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LEGAL CHARACTERISTICS OF THE STANDBY LETTER OF CREDIT

The radically changed nature of risks as a result of the present financial crisis has directed the attention of actors in international trade to security tools of first class.

Although the new financial and economic threats require a new approach in risk management and different measures than before, it is needless to say that the “traditional” credit risks have lost nothing from their importance that means exporters should continue to face with the possibility of non-payment on the side of their buyers.

The worth of financial security instruments above all of bank-guarantees is determined by the financial reliability and creditworthiness of the issuing bank. However, huge losses suffered by global banks having large share in international trade finance such as Citibank, Wachovia or Bank of America have resulted some uncertainty, by implication, the trust in promises for payment made by financial institutions needs to be reestablished.

Since the middle of the 1970s, the international trading community has acquired the knowledge of a very special type of independent securities, the standby letter of credit¹ of US-American origin which has so enormously developed that in 2008 the aggregated value of standby L/C issuance has reached 597.4 billion USD.² Despite its widespread application (it has been used even by Arabic banks), there are some unclear issues relating to its legal nature.

According to the ruling legal opinion in mother country, the standby L/C is to be classified as a contract between an issuer and a beneficiary. There is no dispute between US-American legal experts on the subject that the standby L/C should be governed on the one hand by special regulations for letters of credit³, on the other hand by provisions referring to contracts⁴ included in the Uniform Commercial Code of U.S.

This view has not gained general acceptance in many European countries except those, in which a huge number of standby L/C transactions made it necessary to de-

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¹ Later on called standby L/C.

² FDIC Statistics on Depository Institutions Report 30.12.2008: 597 478 682 000s USD in all commercial banks; In comparison, the value of commercial letter of credit was altogether 24 982 286 000s USD in the same period.

³ Chapter 5. 5-103-118 §.

⁴ Chapter 2.

fine the instrument. The debates have resulted in classification of the standby L/C as a contract which despite its specialties should be ordered into national civil codes¹.

Some European authors, especially bankers represent an other standpoint namely as if the standby L/C was considered to be a promise for compensation of potential losses in future because of the one-side obligation of an issuer embodied in the instrument, and therefore according to their beliefs the standby L/C is more likely to have features of an insurance contract rather than of a mutual agreement.

The related literature on the subject has frequently defined the standby L/C as an irrevocable payment promise of an issuer, but the terminology of “undertaking” - instead of promise - has been also introduced by the usage ISP 98² and the UNCITRAL Convention³.

Despite the above mentioned opinions, the standby L/C should be considered as a bundle of mutual duties to be performed by parties (both by the issuer and the beneficiary) in order to get entitled for the agreed value in exchange for it. The balanced duties of the equal value ought to be required in order to meet the spirit of the instrument as an independent personal security.

The standby L/C is not a simple contract but an “abstract legal relationship”, thereby an issuer’s payment obligation should be thoroughly separated from the underlying business deal, in terms of any breach of it. The protection of the principle of independence has got a general acceptance and has been highly appreciated.

In other words, this independency means that the payment obligation of an issuer should be solely connected to conditions of its own regardless of any event which might occur in the secured transaction.

Notwithstanding this general opinion frequently represented by relevant literature, there are some misunderstandings in this field suggesting as if an issuer had unlimited competence to establish the contractual elements of the standby L/C.

Nevertheless, this confusing standpoint seems to be supported by the fact that issuing banks generally insist upon their model contracts including “General Terms and Conditions” for payments of any type. Without questioning the usefulness of banking standards it is needed to be stated that their use may not lead to a conclusion, namely that the standby L/C as a contract can not be modified even if there is disagreement on the side of the beneficiary. If there were no opportunity to discuss upon its conditions, the standby L/C would only represent the will of an issuer and thereby indirectly the economic interest of the applicant (obligor of the underlying trade transaction), by implication, it will lose its quintessence and would cease to exist as an independent security.

Since the standby L/C should evidently back up beneficiary’s interests in getting the right value for its performance, therefore ignore of them even in part, would make the device pointless.

On the other hand, not only a beneficiary has to make a presentation in full compliance and with perfect result in order to get entitled for the performance of the issuer, but all involved banks should have essential duties to be done in order to

¹ Especially Germany has got a pioneer role in this field. In Hungary there are even disputes about the nature of bank guarantees in preparation of the New Civil Code.

² International Standby Practices issued by International Chamber of Commerce as the main usage for standbys.

³ UNCITRAL Convention on Independent Guarantees.

establish the balance of rights in each standby L/C contract with special respect to justifiable interests of a beneficiary.

Because of the unconditional and irrevocable nature of the undertaking of an issuer, the payment undertaking in the standby L/C might be temporarily suspended or ultimately deleted only in the particular case of a suspected fraud or fraudulent behavior. However, the legal process aiming to shape the framework of conditions relating to the use of “fraud exception rule” as the sole exception from the mandatory payment obligation of an issuer has not even finished.

Notwithstanding the abstract characteristic, the standby L/C has remained a contingent liability above all regarding the banking accounting rules. Its contingency refers to its dependency on the particular event which makes the device operate or active. The dependency becomes clear and evident in the provision of a “clause of effectiveness” since conditions stipulated therein are stemming from the underlying deal so they are able to create a definitive linkage to it. There is a question of high importance whether or not this interdependency is able to ruin the privileged autonomy of the instrument.

It seems to be problematic that the undertaking of an issuer despite its declared unconditional autonomy has even preserved certain dependency on the basic transaction by requiring presentation of documents originating from it and representing the breach of it.

Therefore, in a very paradox manner, the declared independency of the instrument has been based on fulfillment of complex co-existing conditions and terms. In this sense the contingency should be simply treated as the manifestation of the beneficiary’s duty, so it is not more than the expression form of a not-activated payment obligation. The contingency has also nothing to do with conditions provided by an issuer because if it were so this would lead to false interpretation and would turn the standby L/C into a secondary obligation.

On the side of an applicant definitive temptations can be perceived which try to connect the standby L/C to the main contract by defining (or by committing the issuer to define) different documents as a performance criteria. The action of this sort may not be considered as dealings in good faith.

Despite its default instrument nature the standby L/C has quite frequently been issued not to prevent any breach of a contract, in these cases the intention of contracting parties doing so is not present. The sole reason of issuance of the standby L/C of this sort is to use the instrument as a payment method that means that the obligor does not want to manage a money transfer therefore let the beneficiary call the demand. Evidently, there are a few of devices of this type at the financial market in terms of the standby L/C upon first demand requiring as a performance criteria the presentation of a bill (commercial invoice) or of a pure statement for receiving promised money. Notwithstanding this practice it is absolutely necessary to disagree upon it since it might create a faulty illusion about the real purpose of the standby L/C and might erase the exact boundary between the standby and commercial letters of credit.

Unfortunately, the confusing standpoint of this kind seems to enjoy protection from the rules of ISP 98 set up mainly by professionals of International Chambers

of Commerce being especially familiar with documentary credits¹ and disregarding the real default nature of the standby L/C at some provisions of the usage.

It is absolutely important to differentiate the standby L/C as a special form of a bank-guarantee from accessory obligations² in a precise way, because its history goes back to traditional surety-ships³ firstly stipulated in the Code of Justinian.

To sum up the results of the research work, there is a need to define of standby L/C in particular situations when they are connected to regulations of Bill of Exchange laws, or when the norms of BASEL II and the related stipulations of financial supervisory authorities should be taken into consideration as well.

Therefore, the main purpose of creating a new terminology is to describe the standby L/C in its full complexity and to point out ambiguous provisions of the applicable usage and their confrontations with the surrounding legal environment. As a conclusion of the research, it might be stated that changes in international trade is enforcing the revision of ISP 98 and the creation of a new concept and terminology of fraud. However, the practice of application of UCP⁴s to standby L/C is to be liquidated since it is combining two devices of different purposes and orders in a confusing way.

As the result of investigation on the history, fields and risks of uses and applicable laws and related regulations of the standby L/C the author has defined new provisions in order to modify the present ones of ISP 98 which might be able to resolve the existing contradictions and to bring the usage in harmony with national (especially with Roman-German type) laws.

Above all, it seems to be necessary to create a new summarizing definition, which gives expression to the contractual and independent nature of the instrument:

The standby L/C should be considered as a contract that is subject to rules of Civil Codes applicable in which an issuer irrevocably undertakes to perform unconditional payment for a defined event upon first written demand of an obligee if the obligee meets completely and faultless all documentary requirements set by the contract and if the obligee thoroughly fulfils all conditions and terms stipulated.

Contractual duties of the issuer:

- a) *The issuer is obliged to issue a valid statement in which all conditions of its payment undertaking ought to be defined in a clear way;*
- b) *The issuer undertakes not to withdraw its payment promise that means it abandons its right for termination of the contract;*
- c) *The issuer undertakes to examine the presented documents in their face with no regard to any elements of the underlying transaction;*
- d) *The issuer undertakes to inform the obligee about the norms of examinations and in case of a debate is obliged to prove the correctness of its related activity;*

Contractual duties of the obligee:

- a) *The obligee has to present the required documents latest to the expiry date and in full compliance with the terms and conditions of the standby L/C;*
- b) *The obligee has full liability for the formal and content authenticity of presented documents;*
- c) *The obligee has to hand over the title to documents;*

¹ Known as letters of credit as well.

² Bonds, surety-ships, or „Bürgschaft“.

³ In Anglo-Saxon legal environment it is called „guarantee“.

⁴ Uniform Customs and Practices for Documentary Credits.

Unfortunately, the contradictory and ambiguous provisions of the usages and their confusing use have resulted in the lack of balances of power in the instrument.

Therefore, it seems to be necessary to rebuild the structure of the standby L/C as a contract in order to protect the equal rights of the parties and the spirit of the device, by ordering the following:

- a) *The issued standby L/C is to be considered as an offer up to its acceptance by the beneficiary therefore he is entitled to suggest any modification or to refuse it in part or in full.*
- b) *The standby L/C becomes the irrevocable undertaking of the issuer if the beneficiary has agreed upon it in all detail.*

To prove and to secure the unrestricted effectiveness of the principle of independence as the quintessence of the standby L/C, it is necessary to define its abstract nature in a more evident and precise way.

- a) *The promise of payment made by an issuer is to exclusively comply with the conditions of the issuer and therefore its payment obligation is absolutely separated from the underlying obligation for which the standby has been issued as a security.*
- b) *The issuer is not allowed to raise objections of any kind referring to the secured transaction even if the obligor were entitled to do so.*
- c) *Any reference to the secured transaction doesn't affect the independency of the issuer's undertaking for payment.*

Although the main purpose of the standby L/C is to protect the economic interests of a beneficiary, the aspects of the issuer have to be taken into consideration as well.

In this connection the fund given by the applicant as a deposit should belong to the assets of the issuer up till the beneficiary has made a presentation staying in full and faultless compliance with the conditions set by the instrument. Therefore a new provision needs to be introduced relating to the legal status of the fund embodied in the standby L/C, as follows:

The sum certain in money defined to pay by an issuer in the standby L/C is to be considered as the asset of an issuer or of a confirmer from the very time of the issuance up to the time when a beneficiary having a real material right has made a valid standby conform presentation.

It has been always an essential question whether or not to allow the modification of the original conditions of a standby L/C. If the modification were permitted, then it is needed to determine the type of procedure. The creation of following provisions may be useful in solving this problem:

- a) *A standby L/C is to be considered issued, valid and thereby enforceable if it has been finally out of the control of the issuer and it comes into force only from the very moment when the named beneficiary has got it.*
- b) *The issuer should control whether the beneficiary has received it undertaking in an undamaged form. This obligation is to be extended to any performance of the nominated banks committed by the issuer.*

- c) *The time between the date of the issuance or of its modification and the date of the receipt by the beneficiary may not be longer than 5 banking working days.*
- d) *The advice upon issuance should not be imposed on any condition or on any payment of fees of any sort.*
- e) *In case of a dispute the issuer is obliged to give evidence upon the time and the mode of the issuance including the precise content of it.*

The rule of the “fraud exception” has created the opportunity for the issuer to reject the payment lawfully in case of fraudulent demand presented by a beneficiary. The legal means that has been ordered to ensure this special right of the issuer is called “injunction” ,which should be precisely regulated in terms of the privileged principle of independency of the instrument.

Firstly, it is needed to define the exact content of a fraud or fraudulent behavior.

There is a material fraud if:

- a) *Any of the presented documents has been forged;*
- b) *Any data of the presented documents has been falsified;*
- c) *Any of the presented documents has been received in a fraudulent way;*
- d) *There is no material and legally justifiable ground for the demand;*
- e) *There is no doubt that the applicant has fulfilled its obligation secured by the standby;*
- f) *There is no doubt that a deliberate action of the beneficiary in bad faith has prevented the applicant in its performance;*
- g) *The judgment has stated no validness of the obligation for which the standby has been issued;*

If any of the aforesaid conditions is present then the court which has competence over an issuance of an injunction should be obliged to consider whether or not the following four conditions will be simultaneously fulfilled:

- a) *whether or not the plaintiff would suffer an irreparable harm in lack of the injunction;*
- b) *whether or not the damage would extend the measure of that one which might occur in lack of an injunction;*
- c) *whether or not the plaintiff has the likelihood of success on the merits of the case;*
- d) *whether or not the judgment would hurt the public interest;*

As payment obligation made by issuer or confirmer, there is a question of high importance, namely the warranty obligations of the beneficiary.

Therefore, if the beneficiary has got the amount of the standby L/C he will be obliged to take all liabilities towards the issuer, confirmer and any third party who had given proper value for the documents and towards its contracting party of the original business relationship for the followings:

- a) *The demand made by the beneficiary has got a solid legal ground with no doubt that means it has not been in breach with the underlying transaction concluded by the beneficiary and the applicant in any way.*

- b) *The demand presented by the beneficiary has not brought any other contract which was to be completed by the standby L/C in accordance with the intentions of the beneficiary or of the applicant.*
- c) *There has been no fraud or forgery in the demand.*

Last but not least, the problematic of transferability needs some more attention. Both ISP 98 and UCP 600 have clearly stated that the standby L/C may be transferred if it provided so, that means if it permitted the transfer in the context of the document itself.

The formal requirements of a justifiable transfer have been stipulated in an identical way in both usages. The usage of ISP 98 has made the procedure of the transfer more precise stating that it might be permitted not only on time but at any required time if the new beneficiary took over the standby L/C in its full complexity.

Notwithstanding the above mentioned main rule of usages, there is a problem namely that the majority of national laws of Roman-German type reject the transferability of a bank-guarantee at all. In a particular case, if a German or a Netherlands bank issued the standby L/C for an international transaction and therefore it will be subject (in accordance with the *lex fori*) to the national law of the issuer, then it would be absolutely forbidden to transfer the instrument.

In addition the regulations of ISP 98 for the transfer are more likely to have common features with the documentary credit than to comply with the rules of independent bank-guarantees.

For that reason the full deletion of the provisions of the transferability of the standby L/C should be recommended.

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Legal characteristics of the standby letter of credit

Since the middle of 1970s an independent personal security, the standby letter of credit has begun its great expansion in international trade finance, which has preserved in its formal appearance the features of the denominative letter of credit, but which by its legal nature belongs to the family of bank-guarantees. The standby L/C is such a US-American personal security which due to its special legal characteristics may not be adapted to European legal systems of roman-German type without reservation. By highlighting the contradictions between the regulations of applicable and in practice used „usages”, the present article makes an attempt to introduce solutions and methods enabling the separation of the standby L/C from accessory personal securities, such as surety-ships and from its forerunner, the commercial letter of credit. Besides determining the standby L/C as a contract subject the civil code it became indispensable to work out the rights and obligations of involved parties. The definition of contractual undertakings was necessary to the legal foundation of the sole exception of the irrevocable and unconditional payment obligation of the issuer, namely to the formation of fraud exception rule.