

Commercial Letters of Credit

Commercial Letters of Credit (L/Cs) – known as the lifeblood of international trade – is the most widely used method of international payment. This article sets out the nature of a letter of credit and highlights to the exporter or importer the main points to be considered when using an L/C as payment for an international trade transaction.

In an L/C transaction, there are 4 parties involved:

- The Seller
- The Buyer
- The Issuing Bank (Buyer's bank)
- The Advising Bank (Seller's bank)

When an international sale is agreed upon to be paid by way of an L/C, the buyer will take steps to establish through the buyer's bank (usually at the buyer's place of residence) a **letter of credit in favour of the seller**. In other words, the buyer opens a letter of credit for the overseas seller on terms agreed upon in the contract of sale.

By issuing the L/C, the buyer's bank agrees to pay the seller a specified sum of money on presentation of such documents as are required by the terms of the letter of credit. **An L/C thus evidences a contract between an issuing bank and a seller.** It is distinct and independent from the contract of sale although both the L/C and the contract of sale relate to the same transaction.

Prudence dictates that the buyer takes the necessary steps to **open an L/C** giving the buyer enough time to comply with the import licensing or monetary control regulations of the importing country. The best protection which might thus be afforded to a seller is to **request the immediate establishment of an irrevocable Letter of Credit** in the port of shipment, current for the duration of the agreed shipping delay. An irrevocable L/C, once established by the issuing bank, is a commercial credit from which neither the issuing bank nor the buyer can withdraw.

The seller and buyer should confirm that:

- a) The terms of payment in the credit, (that is to say, the currency of the drafts drawn thereunder), are in conformity with the sales contract.
- b) The amount stipulated to be available for the seller is sufficient to cover all costs permissible to be drawn under the Letter of Credit.
- c) The shipping and expiration dates allow sufficient time to execute the order and present the document for payment to the Bank for negotiation.

- d) All documents required by the buyer are mentioned in the Letter of Credit, and the documents are obtainable in the form required.
- e) A full description of the merchandise to be supplied is agreed between the seller and the buyer.
- f) The insurance documents are in accordance with the terms of sale.
- g) The ports of shipment and destination are properly stated.
- h) The loading documents, such as bills of lading required, are properly described.

There are however potential **pitfalls** that parties to a Letter of Credit should be aware of:

1. The credit transaction is entirely independent of the underlying contract for which the credit is extended. Disputes between the buyer and the seller in the underlying contract will not affect the bank's obligation to make payments to the seller unless it is clearly obvious that the seller has been fraudulent.
2. The documents tendered by the seller for payment must strictly be in conformity with the terms of the credit. There is no room for documents to be almost the same, otherwise the issuing bank will not accept them.

Comasters is able to advise a Buyer on the pertinent steps in arranging a Letter of Credit and can put the Buyer in touch with the appropriate financial institution. We are also able to advise a Seller who is intending to receive an international payment by way of an L/C.

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Important: This is not advice. Clients should not act solely on the basis of the material contained in this paper. Our formal advice should be sought before acting on any aspect of the above information.

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