Credit Enhancements in General
Credit professionals often act as checks and balance against their sales department’s potential profit, but perhaps against risky attempts to bring in new accounts. The credit department is responsible for evaluating the risk proposed by a new account and suggesting ways to either minimize that risk or enhance the creditworthiness of the new applicant. There are various ways to enhance the credit of an applicant at the beginning of a relationship, including a cash deposit, a lien on the collateral provided to the customer, requiring either pre-payment or cash before delivery, providing goods on consignment, insisting upon shortened payment terms, obtaining guarantees on affiliates or the principals, and obtaining credit insurance for the account. This article focuses and provides a background on letters of credit (LCs), as well as the advantages of them as a credit enhancement tool.

What are Letters of Credit?
Letters of credit are a method of shifting the credit risk from the customer to a financial institution issuing the letter of credit. There are two types of letters of credit: the first is commonly called a commercial or documentary letter of credit, which is generally referred to as a direct pay letter of credit and is used mostly in international sales.

How does this work? The New York buyer applies for an LC which commits a bank to pay money to the German seller upon the seller’s presentation of certain documents that are outlined in the LC. These documents generally describe the goods in accordance with the LC or include an invoice, policy of insurance and/or certificate of inspection. Once the seller’s documents comply with the LC, the bank would pay the seller. The LC compels the bank to pay money to the seller, even if the buyer thinks the furniture is inferior and otherwise instructs the bank not to pay. After the bank pays the seller, the LC would force the New York buyer to pay the bank, even if the buyer might not be satisfied with the seller’s goods. If the buyer is not satisfied with the furniture, then it would have to take legal action directly against the now fully paid seller.

The second type of letter of credit is commonly called a stand-by letter of credit. This differs from a commercial LC in that the beneficiary uses the LC to secure the performance of its customer rather than to obtain a direct payment for the customer’s obligation. This is the type of LC credit professionals typically use for domestic business. Stand-by LCs function somewhat like collateral because the applicant’s default on its obligations prompts the beneficiary to draw on the LC.

To illustrate, assume a customer agrees to pay for goods or services that the vendor provides. If the customer fails to pay, an event of default occurs under the customer/vendor contract. This event of default should entitle the vendor to draw on the stand-by LC. According to the stand-by LC, the issuer-bank would pay the vendor/beneficiary when the bank receives a written statement certifying that the applicant-customer failed to pay the vendor.
BASIC PRINCIPLES OF LETTERS OF CREDIT
AN LC transaction is a three-party arrangement between the issuer (generally a bank), the applicant (a customer) and the beneficiary (the vendor). First is the relationship between the applicant and the issuer. This usually entails a reimbursement obligation between the issuer and the applicant requiring that the applicant reimburse the issuer for payments made on the LC to the beneficiary. Second is the relationship between the applicant and the beneficiary, and finally is the relationship between the issuer and the beneficiary. This third relationship is reflected in the LC itself, which is the undertaking between the issuer and the beneficiary.

The uniqueness of an LC arrangement is the independence principle. This rule of credit law is central to understanding the importance of LCs. The principle states that the issuer's obligation to the beneficiary is independent of the beneficiary's performance on the underlying contract. In other words, the issuer should pay on the LC, on a proper demand from the beneficiary, even though the beneficiary might have breached the underlying contract with the applicant. Also, the issuer's obligation to pay the beneficiary is independent of the applicant's obligation to its issuer. For example, if the applicant goes into bankruptcy after the bank issues the LC, but before the beneficiary draws upon the LC, the issuer should pay even though the applicant may not be able to pay or reimburse the issuer.

The LC beneficiary is obligated to present conforming drafts or documents. Once the beneficiary does that, the issuer must honor the draft or demand for payment. However, the issuer should deny payment if the beneficiary does not present the proper documents/drafts to the issuer. Determining whether the documents the beneficiary submitted comply with the LC, however, is not clear; the drafters of the Uniform Commercial Code (UCC) deliberately left this matter to case law and practice.

Two standards of compliance exist. One is the strict compliance standard. Strict compliance holds that the beneficiary should comply strictly with the terms of the credit and that any failure of the documents/draft to conform excuses the issuer from its duty to honor the beneficiary's payment demand. The other standard is substantial compliance. Under this standard, the issuer is required to pay the beneficiary if the beneficiary's documents substantially or reasonably comply with the LC. The majority of cases prefer the strict compliance standard. To avoid a problem situation with the issuing bank, the LC should be simple and clear on its face and the draft should track the language of the LC.

WHY LETTERS OF CREDIT ARE FREQUENTLY PREFERRED OVER OTHER FORMS OF COLLATERAL IN BANKRUPTCY
LCs are frequently preferred over other credit enhancements such as third party guarantees, security deposits and liens on assets, all of which would likely be affected by a customer/account party's bankruptcy case. For example, if the vendor held a security deposit or lien on assets, the vendor would be prevented by the automatic stay from taking any action to enforce its secured claim during the bankruptcy case absent a bankruptcy court order granting it relief from the automatic stay. Similarly, the third party guarantee, if secured, may be essentially worthless if the guarantor also files a bankruptcy case.

General principles of bankruptcy law reinforce the independence of the issuing bank's obligation to honor drafts under an LC transaction as opposed to the bank's rights against the now-in-bankruptcy customer/account party. Even after a bankruptcy petition is filed, creditors remain free to transact among themselves, including the ability to freely trade claims. A bank honoring an LC is just that, substituting one creditor for another.

WAYS TO ENHANCE THE CREDIT OF AN APPLICANT
- Cash deposit
- A lien on the collateral provided to the customer requiring either pre-payment or cash before delivery
- Providing goods on consignment
- Insisting upon shortened payment terms
- Obtaining guarantees on affiliates or the principals
- Obtaining credit insurance for the account
Bankruptcy law automatically stays any act to obtain a debtor's property once the debtor files bankruptcy. However, the general rule is that if a vendor's customer defaults on its obligations to the vendor, and subsequently files for bankruptcy, the vendor's ability to make a draw under an LC securing the customer's obligation to the vendor generally should be unaffected by the bankruptcy and should not be stayed or enjoined. Note that there are exceptions. Since the Bankruptcy Code was enacted in 1978, some courts have held that a bankruptcy court has the ability to enjoin, or stay, payment on a letter of credit by a bank (a non-debtor party) to a debtor's customer (again, a non-debtor party) under certain circumstances. These exceptions have found that payment of the LC would somehow have a negative impact on the debtor's bankruptcy reorganization efforts.

Regarding preferences, the general rule is that draws on an unsecured LC within the 90 days immediately preceding the bankruptcy filing generally should be immune from attack in a bankruptcy case as a preference. LCs, however, are not absolutely immune from avoidance as a preference. For example, in response to an issuance of an LC during the 90-day preference period, this may constitute an avoidable preference under the Bankruptcy Code. Some courts have also reasoned that if the purpose of the LC transaction is to secure payment of a debt previously owed to the creditor, and there is a simultaneous pledge of collateral to secure the issuing bank, this may be a preferential transfer because a secured vendor (the issuing bank) would be substituted for an unsecured creditor (here, the vendor) to the detriment of other unsecured creditors.

**ABILITY OF APPLICANT/CUSTOMER TO PREVENT A DRAW IN MATTERS OF BANKRUPTCY**

As explained above, courts generally characterize a beneficiary-creditor’s payment demand under an LC as not involving property of the debtor’s estate. Therefore a draw should not be enjoined.

A few bankruptcy courts, however, have prevented a draw on an LC post-petition. In one case, a debtor convinced the court that the collateral that backed the LC was absolutely necessary for the reorganization of the estate and that the estate would be irreparably harmed if the beneficiary was permitted to draw. Other courts have cited the debtor’s ability to claim "irreparable injury" arising from a higher rate of interest payable on the reimbursement obligation to the issuing bank as compared to the rate of interest, if any, that may be payable to the beneficiary under its contract, and thus enjoined draws under the LCs.

Critics of these cases note that if an LC draw could be enjoined simply because of an account party's bankruptcy, the LC would lose its defining features of independence and prompt payment, and that there is a great public interest in upholding LCs because without them, many types of financing could or would not occur.

Some courts also reason that they will enjoin a draw on an LC because bankruptcy is intended to promote equality among similarly situated creditors, and in the case of a draw under an LC, one unsecured creditor will be treated more favorably than the other. Of course, critics of these cases argue that the creditors are not similarly situated, that one bargained for additional credit protection as compared to the other. Most cases enjoining draws on LCs in bankruptcy appear to be in the minority and these decisions have been criticized by authors discussing the cases.

**LETTERS OF CREDIT ARE A METHOD OF SHIFTING THE CREDIT RISK FROM THE CUSTOMER TO A FINANCIAL INSTITUTION ISSUING THE LETTER OF CREDIT.**

**ABILITY OF APPLICANT/CUSTOMER TO PREVENT A DRAW IN MATTERS OUTSIDE OF BANKRUPTCY**

Courts and Uniform Commercial Code § 5-109 (2004); Sztejn v. J. Henry Schroder Banking Corp. permit the issuer to refuse to pay, notwithstanding the beneficiary’s proper document presentation, if the document "is forged or materially fraudulent," or if "honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant." Note that the issuer has no obligation to dishonor the beneficiary's payment demand; the issuer may honor, despite the fraud, as long as it does so in good faith.
The UCC and courts fashioned the fraud exception carefully. For example, the First Circuit has held that a court may enjoin payment when it “concerns ‘fraud’ so serious as to make it obviously pointless and unjust to permit the beneficiary to obtain the money. [Such circumstances include:] where the circumstances ‘plainly’ show that the underlying contract forbids the beneficiary to call a letter of credit, where they show that the contract deprives the beneficiary of even a ‘colorable’ right to do so, where the contract and circumstances reveal that the beneficiary’s demand or payment has “absolutely no basis in fact”, [or] where the beneficiary’s conduct has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer’s obligation would no longer be served.” (Ground Air Transfer, Inc. v. Westates Airlines, Inc., 899 F.2d 1269 1272-73 (1st Cir. 1990) (emphasis in original) (citations omitted).

FRAUD IN UNDERLYING TRANSACTION

Courts and legal commentators have long been divided as to whether fraud in a transaction should only include fraud in the LC transaction or should also include fraud in the underlying transaction. UCC § 5-109 provides that fraud in the transaction includes both fraud in the LC transaction and one in the underlying transaction. Therefore, if the beneficiary committed fraud in the underlying transaction, the applicant may prevent the beneficiary’s draw by requesting so to the issuer, although the issuer is under no obligation to accept that request. Also, the applicant may ask a court to enjoin the beneficiary’s draw based upon the beneficiary’s fraud in its underlying transaction with the applicant. In Mid-America Tire, Inc. v. Ptz Trading Ltd., 768 N.E.2d 619 (Ohio 2002), the court held that the beneficiary’s fraud in the underlying transaction justified an injunction against the issuers honoring the LC, where foreign buyers promised American buyers they could sell certain goods, many of which the buyer-applicants could not legally import or sell in the United States. The court issued an injunction because honoring the LC would facilitate the seller-beneficiary’s fraud in the underlying transaction, which was to sell the illegal goods.

FRAUD IN THE DRAW

Many cases prompt courts to issue an injunction against payment, or to justify the issuer’s refusal to honor the beneficiary’s payment demand for the beneficiary’s fraud in the draw. In Sztejn (cited earlier), the beneficiary presented invoices and bills of lading describing the merchandise as “bristles”, as the LC required. The beneficiary, however, had shipped cow hair and other worthless rubbish instead of bristles. The court in Sztejn held that the beneficiary was practicing fraud on the issuer by supplying the issuer with fraudulent documents, instead of the fraud merely involving the beneficiary’s breach of the underlying contract.

More recently, the Second Circuit in Brenntag International Chemicals, Inc. v. Bank of India, 175 F.3d 245 (2nd Cir. 1999), issued an injunction against the issuer-bank from making payments to the beneficiary. The beneficiary could draw upon the stand-by LC only when the applicant failed to perform its obligations and only after the beneficiary submitted certain documents, including a default letter stating that the beneficiary did not receive payment due from the applicant. The beneficiary submitted a default letter to the issuer, and the Second Circuit affirmed an injunction against payment because the default letter was facially fraudulent; the default letter on its face was “not true and could not have been true” when the letter was written.