

10-1-1979

Panel Discussion

Follow this and additional works at: <http://repository.law.miami.edu/umialr>



Part of the [International Trade Commons](#)

Recommended Citation

Panel Discussion, 11 U. Miami Inter-Am. L. Rev. 303 (1979)

Available at: <http://repository.law.miami.edu/umialr/vol11/iss2/5>

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Inter-American Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

Panel Discussion*

FROM THE FLOOR: Mr. Kennedy, I wonder if you could explain the reluctance of the local banks to utilize back-to-back letters of credit and perhaps give some alternatives?

MR. KENNEDY: The reluctance of the banks is not related to the back-to-back credit per se. What I tried to say this morning was that you could have a letter of credit issued in favor of an exporter that perhaps is not a client of the bank that is being asked to issue a back-to-back, so that the second credit that you issue on behalf of the first exporter is totally at the first supplier's risk. You could be made to pay under the second credit and, for some reason, performance might not have been made under the first credit; a party could take the merchandise and run.

The alternative that I tried to explain this morning was the transferable letter of credit which accomplishes the same thing and yet does so without any credit risk to the bank. They have made the one credit judgment on the bank and opened up the letter of credit, and now they must transfer it.

DEAN MENTSCHIKOFF: I think you have two things mixed up. Back-to-back letters of credit require precisely the same documentation for both credits.

Let us assume for a moment that we are concerned with a CIF transaction. I need the onboard bills. When the bank issues its first or primary credit, it is going to ask that the credit be drawn to the order of the bank, which means that it can be drawn to someone else's order and then endorsed over to the order of the bank. Thus, there is no way in which those documents can be taken by anyone else. The person who is asking for the issuance back-to-back (the second credit) is the actual seller on, or the beneficiary of the first credit. The documentation remains the same because it will still be to the order of the bank; but there are two pieces of paper that need to be different: the invoice and the draft drawn on the credit.

* Panel Members: Dean Mentschikoff and Messrs. Hornbostel, Kennedy, and Kozolchyk. Mr. Kennedy delivered a lecture on the fundamentals of the letter of credit. His presentation, consisting mainly of visual aids, was inappropriate for inclusion in this volume.

Any banker who knows what he is doing will take the prime beneficiary's invoice draft drawn to the bank's order and never give the documents to the beneficiary, who will simply present under both credits simultaneously. This procedure creates one risk.

We are not, however, discussing the situation of the back-to-back letter of credit, but rather something different. Let us assume that I sell to you CIF and I am buying from someone else FAS. There are two different sets of documents and, in order to convert the FAS documents into those of a CIF transaction, somebody has to do something with the goods, or at least have the carrier shift the nature of the documents, because one will be a receipt for shipment, while the other will be an on board receipt.

This is the simplest situation because you can use a freight forwarder, and the bank therefore has no risk.

Take a third situation: the goods arrive at the railroad station FOB Miami, and I need to get them to Port Everglades and on board a vessel. I need someone to actually move the goods; I may or may not use a freight forwarder. If I have to obtain physical possession of the goods in order to change them in some way (such as repackaging) before they are ready for shipment overseas, then the bank has a problem. This latter situation is the one Mr. Kennedy is talking about: the bank is forced to decide whether or not they want to deal with me. The fact that the bank has issued a credit in which I am the beneficiary does not provide the answer. Thus, you must first distinguish between the two underlying sales contracts. If they carry the same documentation, there is no problem at all. If they carry documentation that is easy to get, the freight forwarder can step in and with twenty minutes work, convert the shipment on board. If the documentation is more complex, then there is a second risk, and you need an assignment of the proceeds of the first credit, which under the Code is as safe as can be.

There used to be a problem with back-to-back letters of credit prior to the Code, because there was a moment when there was nothing: the obligation was unsecured and bankruptcy could intervene. This problem no longer exists because the Code was built to permit letters of credit back-to-back on one risk.

FROM THE FLOOR: Obviously, that has not filtered into the banking system in the South Florida area.

DEAN MENTSCHIKOFF: I do not know. Wilbert Ward, Vice President in charge of International Affairs at Citibank, used to go around the country at the time when all of this was being worked out urging bankers to take the risk of letters of credit back-to-back, even without the protection of an assignment of the proceeds, because it was such a short term risk: the risk would last about five seconds. That break could be crucial under the bankruptcy law. It does not exist any longer, but people do not know that. I think most bankers are not brought up to date as to the law, because, frankly, most lawyers also do not know about it.

PROFESSOR KOZOLCHYK: To agree with Dean Mentschikoff's statement and possibly to clarify so that you see the differences between Mr. Kennedy's statements and Dean Mentschikoff's statements, the problem with the Uniform Customs and Practice (UCP) has been that it has absorbed into the notion of transferrable credits the notion of a back-to-back credit, and you get very, very knowledgeable international bankers speaking as if the two transactions were the same thing. They are not.

If you look through the records of the adoption of the UCP Revision for 1974, you can see that there is an amalgamation. The distinction is one which was pointed out by Dean Mentschikoff: the back-to-back transaction is essentially a secured transaction. It has more of the elements of a secured transaction than the transfer of a part of the original credit, which is a transfer of the credit *per se*. There is no way in which any bank can be prevented from issuing a back-to-back credit. However, the one-transaction prohibition that applies to transfers has nothing to do with back-to-backs. That is to say, you, as a banker, find it perfectly advisable from a risk standpoint to issue a second letter of credit on the strength of the first.

There is no provision in the Uniform Commercial Code (UCC) or in the UCP that should prevent you from doing that because, essentially, you are willing to take a risk on the basis of the security that Dean Mentschikoff has just described, and you take care of the gap that she has described as being the one that pre-existed the enactment of the UCC. On the other hand, the transfer of the letter of credit has to be on the basis of what was stated in the original instrument. This is the distinction between the two types of credit—a distinction, unfortunately, that many bankers do not perceive.

FROM THE FLOOR: At this point, I would like to comment that in actual practice, the bank will not issue back-to-back letters of credit. I would also note that in terms of taking an assignment of the proceeds, there are two problems. First, you have to dispose of the terms of the first credit, which may not be commercially desirable, in order to convince the assignee that he is going to get paid. Second, when you are representing the assignee, the payment is only going to be made if the credit is negotiated. Since there are other ways of getting payment, you could steal the goods from the first supplier.

DEAN MENTSCHIKOFF: I am sorry, but I do not understand your situation. You are saying that the person who does the assignment of the proceeds of the credit is the beneficiary of the first credit, and if the bank that issued the first credit does not care to participate in the transaction, he has to disclose the credit to the second bank that he goes to. If you are referring to the first bank, it knows all about what is in the credit because it issued it. Perhaps I am confusing what you are saying.

FROM THE FLOOR: I may have a contract to supply goods that I am going to purchase, and I do not want to disclose my profit to the person from whom I am going to purchase. In order to get an assignment, I have to show him my letter of credit.

DEAN MENTSCHIKOFF: No, I am sorry, you do not assign to him. You assign the proceeds of the letter of credit to the bank.

FROM THE FLOOR: And the bank opens a credit in favor of the supplier?

DEAN MENTSCHIKOFF: That is right, because you are the customer.

FROM THE FLOOR: That is what the banks will not do.

DEAN MENTSCHIKOFF: Some will and some will not. It depends on whether they understand what they are doing. I think you are

talking about the situation where there are two different sets of documents. If you are selling CIF, you are the beneficiary; and if you are buying CIF, you have the same set of documents.

FROM THE FLOOR: That I understand, but the problem arises . . .

DEAN MENTSCHIKOFF: . . . only when you do not have the same set of documents.

FROM THE FLOOR: The banks will not do it.

DEAN MENTSCHIKOFF: If I were a bank and you had a credit issued by Citibank calling for the same set of documents, I would be delighted (even if I were not Citibank).

MR. KENNEDY: I think the question is the pure assignment of proceeds. You are correct in that if the letter of credit is issued in favor of the ABC client, he is the person who has to return to the bank and request an assignment of the proceeds. The bank will then send to the XYZ company, not a copy of the letter of credit, but simply a statement that: "Out of a hundred thousand dollars, you are hereby assigned a hundred thousand dollars out of the letter of credit, in favor of ABC." What can happen then, as you suggested, is that the assignment is only as good as ABC's presentation to the bank, assuming that negotiation with the bank of the documents is found to be in order. If all of this happens, the bank has confirmed that out of every letter of credit drawn, you will get twenty percent or thirty percent, or whatever.

DEAN MENTSCHIKOFF: He has confused them.

FROM THE FLOOR: For me to know that there is going to be a hundred thousand dollars' worth of proceeds, I have to see the terms of the credit. If I am the supplier and the bank sends me a letter stating: "We have irrevocably confirmed the assignment of proceeds by ABC to your firm . . ."

MR. KENNEDY: “. . . of a certain amount of money . . . ten thousand dollars”

FROM THE FLOOR: If ten thousand dollars are created by the negotiations, and if I am representing the supplier and the letter of credit is at ten dollars a unit, and he has offered to pay me twelve dollars a unit, there is not going to be enough money to pay me in that letter of credit.

MR. KENNEDY: Of course, we would not assign ten thousand dollars if there were only a five thousand dollar credit. If the letter of credit is for twenty-five thousand dollars, we will assign you anything up to the twenty-five thousand dollars.

FROM THE FLOOR: If there is a partial shipment permitted, I may come in with less than all.

MR. KENNEDY: You may have a pro rata draw-down.

FROM THE FLOOR: It is very dangerous to take an assignment of credit anyway.

MR. KENNEDY: It is certainly not as good as the back-to-back credits that some banks will issue and not as good as a transferrable credit.

FROM THE FLOOR: Mr. Kennedy, will your bank handle back-to-back credit?

MR. KENNEDY: No, we have made it a rule at Citibank for the past few years not to handle back-to-back letters of credit unless the client is of a type such as General Motors, where there is no credit risk at all. I understand Dean Mentschikoff's point, however; if you get the documents drawn up ahead of time so that you have enough to draw on a second credit, there is less risk. Nevertheless, we do not

enter into those types of transactions unless a good client requests that we do so.

FROM THE FLOOR: I would like to ask Professor Kozolchik and others to comment on the CIF contract terms. As I understand it, the UCC provides that in a CIF contract, the risk of loss passes at the port where the cargo was loaded aboard ship, whereas in a UCP document (not a code), a CIF contract means that the risk of loss passes only when the buyer receives the goods. Would you please comment on that?

PROFESSOR KOZOLCHIK: I think your reference is not to the UCP, but to the INKO terms. There may be a bit of discrepancy between the INKO terms regulation or customary compilation of CIF terms and the UCC. The INKO terms have little validity. I have seen very few courts in this country applying INKO terms at all, particularly when the UCC provisions are very clear on that point. I will let Dean Mentschikoff comment on that.

DEAN MENTSCHIKOFF: You have got to remember that the INKO terms were drawn in French where CIF meant cost and freight only. When it is CIF in the American or English sense, it is cost, insurance and freight; there is just no way in which title to property can pass at any time other than at the time of shipment. Why else are you taking out insurance? If it is a C and F transaction—one that has created a great deal of confusion in the courts because the code says that C and F has the same impact as CIF—then as far as property is concerned, this just means that the buyer has warehouse-to-warehouse insurance, or something of that nature. It should not make any difference, but it still does in some countries. There is nothing that you can do about it except to provide in your contract, if you are dealing with somebody in a country with that kind of origin, that the C and F terms also pass the risk at the same time.

Normally, there will not be any quarrel with this because somebody has to have insurance. There is no way in which you are going to move without insurance when you are dealing with overseas transactions, and these are all overseas transactions. The only question is whether the seller gets the insurance for the account or whether the

buyer already has warehouse-to-warehouse insurance, and this question is asked during negotiation of the sales contract. In the Soviet Union—I think this is one of the things that always fascinated me about it—they do not have these problems because they name the vessel both times. They do not have to have a law about it; they just put it in the sales contract. We are a little unsophisticated when it comes to sales terms.

FROM THE FLOOR: This question is for Mr. Hornbostel. The question is not so much connected with financing, but with practicality. What do you do when an undercapitalized client comes to you asking for financing? What practical recommendations do you make?

MR. HORNBOSTEL: Is it a United States company?

FROM THE FLOOR: Yes, a U.S. company that is really undercapitalized and wants to start financing exports. Mr. Kennedy mentioned that Citibank would give General Motors a back-to-back letter of credit. What recommendations do you have for clients who are not General Motors and have something, but are undercapitalized?

MR. HORNBOSTEL: This is not really something that I can give you an awful lot of good advice about because almost all of my clients who are in this position are foreign and come from countries which have something that we really do not have, namely, a development bank. Not only are development banks available in each country, but the International Finance Corporation (IFC) in Washington takes equity positions. In fact, the IFC prefers to couple their equity positions with loan capital, for participation in the equity of a given company is likely to attract other potential investors. I have seen this happen several times where a company has tried to put together a reasonably large project somewhere for which it is clearly undercapitalized, and it has gotten really quite effective help from the IFC.

There is also OPIC, as I mentioned this morning, which, if it will not provide equity capital, will provide both the insurance and full-type guarantees which ensure an equity investor not only against political risks, but also against commercial risks.

Besides taking a long time, these ventures are very complicated things to structure, principally because—at least if you are talking equity financing—you do not have much in the way of available guarantees or available insurance. You can get specific risk insurance, as I said, and sometimes you can get other OPIC insurance.

I suppose that the handiest and easiest route for undercapitalized companies in this country who wish to invest abroad is to launch a joint venture. Ideally, such a plan would be concluded with an established, overcapitalized company in the foreign country. I think you will find that the severe constraints, particularly on foreign exchange remittances since the so-called oil crisis, mean that a lot of money that might otherwise be coming back into the United States or going back to Europe cannot be removed from a lot of developing countries. As a result of this situation, there is not really a capital shortage in the country (at least on the equity side) because there has been an inability to remit, or to remit over any level.

In Brazil, the country with which I am, perhaps, most familiar, an American subsidiary can remit—at least by law—whatever it wants in terms of dividends or profit remittances, but the withholding taxes go up radically to about sixty percent of the remittance depending on how much you are trying to remit.

There is a twenty-five percent withholding tax for up to twelve percent of the registered capital; forty from twelve to fifteen; fifty from fifteen to twenty-five; sixty for over twenty-five. Except for the last situation, you can of course take a credit here, provided that you are in a position to do so on your tax return.

There is an alternative in other countries: you can reinvest and to the extent that you do so, your dollar-registered capital will increase. Even though it is reserved, this capital is treated as though it were dollars invested. The result is that in the future, remittance takes place on a much larger base. This practice has had a markedly noticeable effect in Brazil. I think that a company coming into a country may do well when dealing with a company already established in that country, which, for that very reason, may be capital rich.

Finally, such companies can also look to their own commercial banks here who can at least point them in the right direction, although they will not finance equity as a rule.

FROM THE FLOOR: Mr. Hornbostel, you seemed to have been cut off from your outline in your talk before lunch, and I was particu-

larly interested in hearing you speak about the letters of credit problems in your own experiences.

MR. HORNBOSTEL: When you are dealing with letters of credit, you are getting enmeshed in quite technical areas of law where the bankers and letter of credit people who are not really involved with you are putting the deal together. You discover things like terminal dates, which are just put into the agreement, after the fact. Suddenly, you find the credit is going to expire because there is a terminal date within it, and then you have to go through a rather complex procedure of which you were unaware.

I currently have a number of cases in which the letters of credit have expired and the lenders are not happy with the borrower, because the borrower has come up with some documentation not related to the letter of credit, but to the loan agreement. You wind up in a situation where the letter of credit cannot be extended (although the bank has no problem in principle) because lenders are unhappy with some other clause in the loan agreement and will, therefore, not extend the credit until that is worked out. From the U.S. supplier's standpoint, the problem is that he is usually left with a very large exposure in terms of goods which he is unable to ship and which he does not really know where to store. Further, there is no money to pay for it until Eximbank and the commercial bank agree to the extension.

FROM THE FLOOR: This is a question directed to Professor Kozolchyk having to do with standby letters of credit.

Our big problem, of course, is getting any U.S. bank to issue the standby letter of credit. There are two types that we have had to negotiate on behalf of clients. One type is the letter of credit used to secure advance or progress payments under a contract. The second is the standby letter of credit used to secure performance under the contract, which is slightly different in wording. You have performance guarantees in the contract, and you either retain five percent or ten percent of the contract price, or you are prepared to accept the standby letter of credit.

With respect to the advance payments, we have not had that much of a problem, because generally the supplier has a letter of credit for the entire project, so that even if they call on the advance payments and, in fact, deliver in due course, they get paid. What

happens with the performance guarantee is that it is almost a demand letter of credit; such is the case in Saudi Arabia, Iran, and elsewhere. The customer in that country calls on it and abides by its terms, and then the bank, obviously induced by the customer, refuses to pay on the letter of credit. What has been your experience in those cases?

PROFESSOR KOZOLCHYK: In the performance situation, and not in the advance payments situation, are you describing a case where the customer calls on the beneficiary of that letter of credit and says, "I have performed," or the beneficiary says, "I am sorry; you have not performed as you were supposed to, so pay me as you are supposed to for non-performance?" Which kind of situation are we dealing with, the positive one or the negative one?

FROM THE FLOOR: In the first situation, let us say that the beneficiary is the person who is buying from the U.S. company, and he has a letter of credit by which he can get paid by depositing a document that says, "They have not performed in accordance with Articles X and Y of our contract." The issuer (or the customer) of the bank that had issued the letter of credit has in fact performed; there is an arbitrary calling-down of the letter of credit. The second situation is where he has, in fact, not performed but induces the bank not to pay, even though the call on the letter of credit is legitimate.

PROFESSOR KOZOLCHYK: The person who is inducing the bank not to pay in the second situation would be the party who was supposed to perform under the agreement. Is that correct?

FROM THE FLOOR: Right.

PROFESSOR KOZOLCHYK: That is where I got confused with your terminology of customer and beneficiary. Your question is: What is my experience with the second type of a letter of credit, where there is an honest call for the letter of credit to be paid based upon a certificate of noncompliance, and the bank refuses to honor the certificate of noncompliance?

The area of liability that you are talking about is one in which it is a great help to have something like Article Five of the UCC. Even

though the UCP tells you that banks are concerned only with documents and not goods, and defines irrevocable credit as an obligation which is direct and independent, the cases that I have seen are those in which the courts in these countries have deemed it a public policy. The question becomes whether the bank's liability attains or pertains to something in which there is a very fundamental governmental interest.

A very important, but unnoticed decision in American law is one that involved, I believe, First National Citibank of New York, which had a correspondent relationship with Idi Amin's Central Bank. Idi Amin decided, as a result of what he called an act of state, that no letter of credit, either standby or otherwise, was to be issued to pay anyone of the Jewish faith or anyone who had any relationship with the State of Israel. He said: "This is an act of state; it being an act of state in Uganda, United States courts have to honor this decree under the act of state doctrine. . . ." The New York courts answered him with: "Sorry, we do not go this far with the doctrine of act of state."

What you are alluding to is another situation where the act of state in the jurisdiction in question prevails. I have seen the invocation of the doctrine of act of state to prevent a bank from paying on standby credits, and of course, it has been upheld in those situations.

FROM THE FLOOR: This is a comment in relation to what was just said. I represent a bank, and I have been lambasted from time to time about not knowing anything about international trade. There is an apparent reluctance on the part of the Florida banks, especially in Miami, to get involved in a situation where you are dealing with performance-type guarantees. The reason for the problem is the fact that, to a large extent, courts here do not understand, or refuse to understand, the nature of a letter of credit. We are thus involved in a situation where we almost have to interplead funds on some wild theory even though we may retain some interest in the funds.

The reason for the reluctance to go along with that type of standby letter of credit very often is the fact that the banks have been burned when they go into court; they are sued by one party or the other for failure to perform or for their performance under the terms. This is a very unfortunate practical aspect of the situation.

DEAN MENTSCHIKOFF: Standby letters of credit have always been a problem for banks and for courts because you are actually

getting construction bonds where you are not supposed to get them issued. Banks are, in fact, guaranteeing performance, an activity which is clearly *ultra vires* for any national bank, if not for state banks. We skirt the issue in that we do not use the terminology "guaranty;" we just issue letters of credit. On the other hand, the courts look at the reality of the situation and say, "My God, it cannot be that you are throwing away all of that bank's money just because somebody says that there has been no performance."

That kind of reaction is not as common if you get a certificate from someone other than the beneficiary. If he presents the demand accompanied by the certificate, then it looks more like a documentary credit. When it is the beneficiary's own piece of paper, it does not really look much like a documentary credit. In fact, it makes people dream of the traveler's credit that Boris Kozolchyk was talking about originally.

FROM THE FLOOR: The problem, of course, is that in a number of countries they have now adopted very absolute rules about the type of standby letter of credit that they will accept. Obviously, in representing sellers to those countries, we try to obtain letters of credit that require either third-party certification or the award of an arbitration tribunal. In this country, however, if you want to do business, you have to agree to provide what I call a "demand" standby letter of credit. All you have to do is demand payment, and it is put into the form of a document. In actuality, it is a demand letter of credit, and it has been very tough for American companies, particularly, to get this kind of a letter of credit.

Under the Federal Reserve Rules, we cannot issue guarantee letters, unlike the European banks, who can; we are therefore stuck. I sympathize with the banks, because they are caught in a bind. If they issue a letter of credit, and it is called and they pay it, they run the risk of the person on behalf of whom they issued the letter of credit either going bankrupt—because the amounts are huge—or his saying: "Look, I notified you that it was an arbitrary demand, and you still, with full notice of the fact that this was the case, went ahead and paid it." Banks are thus exposed to possible suit by their own customer, or in the alternative, being sued by the beneficiary of the letter of credit upon refusal to pay.

DEAN MENTSCHIKOFF: Have you tried having your client bring an action to enjoin the bank from payment on the basis of fraud?

FROM THE FLOOR: We have had two instances where the situation arose and, in one instance, were able to induce the bank not to pay.

DEAN MENTSCHIKOFF: With a guarantee from you to hold them harmless; I understand that.

FROM THE FLOOR: In the other case, we were on the other side, and the bank refused to pay because their customer told them not to pay. We were able to prove to the bank, not in a judicial proceeding, but in sitting down with them, that their customer was wrong. There had not been any performance, and therefore, it was legitimate that it be paid.

As a practical matter, my clients generally will ask their customer to take back an indemnification, but as soon as the entire payment generates to suit, everybody screams and it becomes a very complicated and sticky situation.

DEAN MENTSCHIKOFF: It is one.

PROFESSOR KOZOLCHYK: That is why I was focusing this morning on the business of the injunction, the distinction of the injunction as a remedy in this country, and what is available in other countries (except Germany). When you have to prove that you have a property right to something—in this case, the bank's liability to you as the beneficiary, if you are the beneficiary of that credit—it leads to ambiguous and circular reasoning. More importantly, this is where the wisdom of UCC § 5-114 appears as a much more sensible way of dealing with this situation, by placing it first in the discretion of the bank. The bank may, when notified of fraud, proceed not to pay. The UCC says that the bank cannot be sued at this point; the bank can withhold payment, and at the same time, there is a possibility that the bank may be enjoined.

The injunction is such a good device for this type of situation because it is conceived for extraordinary cases and is essentially procedural in nature. It has very little to do with notions of the property of the claim, such as typified by the French or Italian injunction. In the countries that follow those rules, you have a serious problem. To

this add on current problems with the act of state doctrine which the courts are generally interpreting as follows: "Whenever a foreign government tells the bank either to pay or not to pay on the standby letter of credit, that is it; the bank cannot do anything about it, at least extraterritorially."

MR. HORNBOSTEL: This is a question which Professor Swan raised at lunch, namely, can you really handle Eximbank, IFC, OPIC, or other such transactions from Miami, or do you need to be in Washington?

In accord with my own interests, I wish I could tell you that you had to be in Washington, but it is not true; you can certainly handle those transactions from Miami. Not only are there good publications available, but, if you are interested, Eximbank invites their correspondent banks to Washington about every six months for a full day's program, updating everyone on what Eximbank is thinking at that particular time. If you are interested in participating in one of these programs, I am sure that if you write them a letter and say that you are entering into this field and would like to attend, they would be happy to have you there. I do not know of anything similar at OPIC, although I think they do something like that occasionally. The IFC does not, but they do have very good publications describing their procedures.