South Carolina Law Review

Volume 22 | Issue 3 Article 4

1970

Letters of Credit: Their Use In Domestic Financing

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LETTERS OF CREDIT: THEIR USE IN DOMESTIC FINANCING

I. Introduction

Letters of credit usually bring to mind international trade. In the past where international merchants have been unfamiliar with each other's credit, the letter of credit has been an excellent device for securing payment to the seller at a nominal cost to the buyer. The only credit or reliability with which each party is concerned is that of the issuing bank. When the bank is internationally known the seller feels even more secure in payment because of the bank's sound financial standing.

More recently, letters of credit have been used on the domestic level. This financing device can be used as either a primary or secondary means of financing. If the letter of credit is used as a primary source of financing, the seller draws drafts on a bank and the buyer is obligated to reimburse the bank from either funds of his own or a loan. However, if the letter of credit is used as a secondary means of payment, that is, if it is to be utilized only upon the happening of a contingency the occurence of which is doubtful, the seller rarely demands payment and the letter of credit is simply permitted to lapse. Where the letter of credit is a secondary means of payment, the bank in reality is guaranteeing payment to the seller in the event the buyer does not pay from another source. Virtually all Commercial transactions can operate under a uniform code which facilitates the flow of commerce by coupling Article 2 (Sales), Article 5 (Letter of Credit as Initial Financing), and Article 9 (Secured Transactions).[1]

The purpose of this note is twofold: 1. To explore Article 5 as a means of financing on the domestic level. 2. To explore the possible use of letters of credit in the construction business. Domestic use of letters of credit, while not yet commonplace, has been successful in the past.[2] However, as far as research shows,

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1. Forty-nine states have now adopted the Uniform Commercial Code. Louisiana has not adopted the Code as yet. There are some minor differences in the adoption by each state but, generally speaking, the statutory structure is the same in each state. Judicial interpretation can, and probably will, cause some variation in treatment and application of the Code.

2. *See* Wiley, *How to Use Letters of Credit in Financing the Sale of Goods,* 20 Bus. Law. 495 (1965).

the use of letters of credit in the construction business is indeed a novel idea.

II. MECHANICS OF ARTICLE 5

While there have been intelligent attacks on the desirability of including Article 5 in the Uniform Commercial Code,[3] the Code has only codified into statutory law that which was previously covered by non-binding methods of practice.[4] Article 5 does no more than make statutory and more definite that which previously was suggested by practice. But Article 5 does not cover every situation. It attempts to cover only those transactions which require documentary titles as a condition precedent to honoring drafts drawn on the credit.[5]

Article 5 does not bring any strange animal into commercial transactions. While the usual banking terminology is used, banks are not the only institutions issuing letters of credit which Article 5 covers.[6] However, since banks are the usual issuers of letters of credit, this note will confine its comments to banks only.

In the usual situation there is a buyer who wishes to purchase goods from a seller. The seller does not want to extend credit to the buyer without some security, as in the case where the buyer and seller are from widely separated parts of the country, or where the seller is not familiar with the buyer's credit, or where both of the above factors are present. Thus, the letter of credit is issued by a bank to the buyer on behalf of the seller, and the bank becomes obligated to the seller for the amount of the credit extended should the buyer choose to use it. Under

3. *See* Mentschikoff, *Letters of Credit: The Need for Uniform Legislation*, 23 U. CHI. L. REV. 571 (1956), where the New York Law Revision Commission is quoted as stating that "the desirable objective of uniformity, both nationally and internationally, is now obtained to a high degree by decisional law and commercial usage." *Id.* at 571-72 & n.2.

4. The only guide to how letters of credit were handled prior to enactment of the Code is the Uniform Customs and Practices for Commercial Documentary Credits which was issued by the International Chamber of Commerce and adopted by American banks in 1952 as a statement of practice. South Carolina, prior to enactment of the Code, had no statutory treatment of letters of credit. *See* South Carolina Reporter's Comments, S.C. CODE ANN., § 10.5-101 (1966).

5. S.C. CODE ANN. § 10.5-102(3) (1966). [For convenience, all cites will be to the S.C. CODE ANN.; for clarity, the *id.* form will be used only when the subsequent cite is identical to the preceding one.]

6. S.C. CODE ANN. § 10.5-109(3) (1966) provides that a non-bank issuer is not bound by any banking usage of which it has no knowledge.

the Code, the seller is called the beneficiary and the buyer is called the customer.[7]

Usually the customer's bank, the issuing bank, will contact a bank in the beneficiary's area to notify the beneficiary of the credit. This bank is called the advising bank.[8] Should the advising bank agree to honor drafts drawn on the credit, it is called the confirming bank and has the same rights and obligations of the issuing bank.[9] Of course, the confirming bank is entitled to reimbursement the same as the issuing bank.[10]

While there are no formal requirements for a letter of credit, the credit must be in writing and signed by the issuing bank.[11] If the credit is a "clean" credit[12] the Code requires that it be labeled as such if the issuer is a non-bank. Further, as in Article 2, no consideration is required to establish a credit or to modify its terms.[13] Thus, neither the customer nor the beneficiary has to prove consideration.

The Code also covers revocable and irrevocable letters of credit. In the former, the credit can be modified or cancelled by the issuer without notice or consent of either customer or beneficiary.[14] However, should an innocent third party accept or negotiate a draft drawn on the credit in good faith and without any knowledge of its cancellation or modification, he is protected.[15] The irrevocable letter of credit can only be revoked with the consent of the customer, and, once the beneficiary receives the letter of credit, it can be revoked or modified only by consent of all three parties.

If the transaction calls for several shipments to be made, and the parties plan for the seller-beneficiary to draw several drafts

7. S.C. CODE ANN. § 10.5-103 (1966) defines the various terms used in a letter of credit. Note should also be taken of definitions in the S.C. CODE ANN. § 10.3-410, 10.2-106, 10.3-104, 10.3-302, 10.4-104, 10.8-102 (1966). *See also* Article 1 for definitions and principles of construction which are applicable to Article 5.

8. S.C. CODE ANN. § 10.5-103(e).

9. S.C. CODE ANN. § 10.5-107(2) (1966).

10. *Id.*

11. S.C. CODE ANN. § 10.5-104(1) (1966). Also any modification of the credit must be signed by the issuer or confirming bank.

12. S.C. CODE ANN. § 10.5-102(1)(c) (1966). When a clean credit is used the beneficiary simply draws drafts on the credit and does not have to present any documents with the drafts to have them honored.

13. *Compare* S.C. CODE ANN. § 10.5-105 *and* § 10.2-209(1) (1966).

14. For all practical purposes most letters of credit are irrevocable and are so stated plainly on the letter. Otherwise the seller would not have the maximum security he is seeking by accepting the credit.

15. S.C. CODE ANN. § 10.5-106(4) (1966). *See* official comments. The issuer is still obligated to an innocent third party provided the third party meets the qualifications of § 10.5-106(4).

against the credit, a "notation" credit[16] can be utilized. That is, if the credit is to be used at the discretion of the beneficiary, the credit can be used in portions.[17] The proper method of using this device is to require notations of the amount of the credit and the amount drawn on that credit on each draft. When the total amount of drafts equals the total credit, the credit will be exhausted. The seller-beneficiary when drawing drafts of a specified amount, must release title documents or invoices to the bank and cannot retain a lien against the title or documents to the goods.[18] This gives the bank maximum security in the documents.

In addition to the warranties of Articles 3 and 4 which apply to documentary drafts, Article 5 provides that when the beneficiary negotiates or otherwise transfers the instruments, he warrants that the necessary conditions of the credit have been complied with. However, a bank in presenting or transferring a draft warrants only those warranties found in Article 4.[19]

The Code treats the letter of credit as an independent financing instrument and completely divorces it from the underlying contract of sale. This, of course, relieves the bank from any concern with the quality of the goods, any breaches between buyer and seller, or any warranties arising out of Article 2. All rights, remedies, and obligations arising from the contract of sale are strictly between the buyer and the seller.[20] Thus, the bank is more prone to issue a letter of credit and a beneficiary is more ready to accept one.

Just as the bank is not responsible for the quality of the goods, it cannot use the seller's breach of warranty as a defense in an action against it for dishonoring any drafts drawn on the credit.[21] The bank is obligated to the customer to use good faith in examining any documents when presented to make sure they conform to the terms of the credit;[22] upon breach of this good

16. S.C. CODE ANN. § 10.5-108 (1966).
17. S.C. CODE ANN. § 10.5-110 (1966).
18. S.C. CODE ANN. § 10.5-110(2) (1966) expressly prohibits this.
19. S.C. CODE ANN. § 10.5-111(2) (1966). The beneficiary's warranty that all conditions of the credit have been met extends to all interested parties. The banks warranty, if that of an intermediary, is covered by section 10.7-508 and section 10.8-306, and, if that of a collecting bank, is covered by § 10.4-207.
20. *See* S.C. CODE ANN. § 10.5-109 (1966).
21. The letter of credit creates an obligation to pay independent of the underlying contracts of sale.
22. S.C. CODE ANN. § 10.5-109(2) (1966). *See also* Caloric Stove Corp. v. Chemical Bank and Trust Co., 205 F.2d 492 (1953) where the bank issued a letter of credit and the customer instructed the bank to pay only if the bill of lading corresponded to seller's invoice. The bank paid and the bill of lading did not conform to the invoice, and the bank was held liable for wrongful payment.

faith duty to examine should the documents not conform, the bank can be held for wrongful payment. But if the bank suspects that something is wrong with the documents it can take an indemnity from the presenter.[23] Thus, should the customer later be absolved from reimbursing the bank for the payment, the bank is protected.

III. PRACTICAL USES

To illustrate the use of letters of credit on the domestic level in normal commercial transactions, assume that there is a travel trailer retailer in Columbia, S. C. Assume further that the hub of the travel trailer industry is in Oklahoma or Texas. Moreover, our local retailer is interested in attending an industry convention and display in that area and possibly in making purchases in a large quantity. He knows that he will require some financing, and he would rather have the financing done on a local level. He also knows that the manufacturer in Texas will probably want local financing in Texas. The buyer-customer can go to his local bank in Columbia and obtain a letter of credit to take with him to Dallas. The local bank in Columbia can arrange for a bank in Texas to advise and confirm the credit and to honor any drafts on the letter of credit. Then, should the buyer decide to place any orders with the manufacturer in Texas, he has instant financing which should be acceptable to the Texas seller. The seller knows he can obtain local payment of the buyer's drafts at any time before the expiration date of the letter of credit.[24]

Further, due to the fact that letters of credit are relatively cheap,[25] if the buyer and seller can agree to wait from 60 to 90 days before drawing drafts on the credit, the buyer could move a good portion of his inventory before he would have to reimburse his local bank. This idea is based on the assumption that the credit would be irrevocable and its duration would be for one year. The irrevocable letter of credit would protect the seller from having the credit cancelled. In addition, this would

23. *See* South Carolina Reporter's Comments, S.C. CODE ANN. § 10.5-113 (1966). Section 5-113(1) gives a bank the right to give an indemnity. Thus, the act on the part of the bank would not be ultravires.

24. After the credit is established it continues until the expiration date shown on the letter, provided the credit is irrevocable.

25. Originally, banks charged one fee at the issuance of the credit. The practice now is to charge a small fee at issuance (about one-eighth of one per cent) and another small fee if the beneficiary actually uses the credit. This second fee usually averages one-eighth to one-fourth of one oer cent. Thus, the price is nominal indeed.

prevent an unscrupulous seller from obtaining double payment. As a bonus to the buyer's local bank, the buyer could finance all of his retail sales through his local bank, with recourse if necessary. When the time comes for the seller-beneficiary to draw his drafts on the credit, the buyer-customer could obtain a loan from the South Carolina bank to cover the reimbursements due on the drafts. The seller-beneficiary could secure this loan by giving the bank a purchase money security agreement, a security interest in the remaining inventory, and by assigning any accounts receivable.[26] The local bank then would have earned interest on three separate accounts comprised of the same funds: the letter of credit, the purchase money loan, and the consumer sale.[27]

The primary advantages of the letter of credit in this transaction are twofold. First, the buyer can save on his financing costs and, second, the bank or financer is provided maximum security for its role in the transaction.[28] This type of transaction would work best in cases where the goods to be sold require consumer financing on a wide scale. In such a situation both the retailer and consumer will usually require some financial assistance to make their respective purchases. Use of the letter of credit in this type of arrangement could also help the independent retailer compete on a cost basis with the large chains.

IV. THE USE OF LETTERS OF CREDIT IN THE CONSTRUCTION INDUSTRY

Interest rates are high; money is tight. The need for housing is in a critical state, but the construction industry is unable to come close to meeting this need because of tight money. It is not enough to say that high prices for money are cyclical, that the interest rates will come down eventually, and that this critical demand for housing will begin to be met. Even if the rates come down tomorrow, they are still cyclical and could go back up at any time, thus stalling the industry in the future when the housing needs will be even more critical. A way has to be found to lower the price of money for construction, and at the same

26. S.C. CODE ANN. § 10.9-107 (1966).
27. This interest rate would be at the going consumer rates and the bank could also take a security interest in the camper from the consumer.
28. *See* S.C. CODE ANN. § 10.5-102 (1966); Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market,* 22 BUS. LAW. 1105 (1967); Wiley, *How to Use Letters of Credit in Financing the Sale of Goods,* 20 BUS. LAW. 495 (1965).

time, insure a reasonable interest rate for the future. Legislation to place a ceiling on rates charged for construction loans is not the answer, for lenders will then get out of the construction industry altogether, lending their money in more rewarding money markets. The answer lies not in lower legislative interest rates, but in an alternative to the construction loan which, because of the high interest rate it carries, increases the cost of housing at a time of grave need for decreases in such costs. Such an alternative, it is submitted, is found in the letter of credit device explained earlier.

The purpose of the construction loan is to finance the construction of a structure; that is, to enable the builder to pay off the suppliers and laborers during the construction of the building without their having to await the sale of the building to receive payment. The builder is usually not in a financial position to build a structure of any type without such a loan.

As an alternative to the construction loan, the builder could use a letter of credit to finance the construction. He would simply obtain a documentary irrevocable letter of credit from his bank, or from any lending institution.[29] The amount of the credit would be based on the estimated material and labor costs of the house to be built. Then, as materials are delivered to the construction site by the suppliers, they would present their bills to the issuing bank for payment and not to the builder. Along with the bills, the supplier would present documents, such as signed receipts, etc., evidencing delivery to the builder of the requested material. The issuing bank would then pay the supplier. The credit would then be debited for the actual amount paid to the supplier, and converted into a loan to the builder at an agreed upon interest rate. This procedure would be followed for all suppliers presenting their bills and documents to the bank for payment.

Labor costs would be handled in much the same manner. Before each pay period, the builder would present to the bank his request for the requisite amount needed to pay his labor costs for that period, with such other proof as the lender may require. This amount would also be debited to the balance of the letter of credit and converted into a loan to the builder at the applicable interest rate.

At the completion of the house, numerous small loans would be outstanding between the bank and the builder which would

29. S.C. CODE ANN. § 10.5-102 (1966) and official comment 1.

be paid off by the proceeds from the sale of the house. The total cost of these small individual loans would be considerably less than the cost of a construction loan.[30] Also, the cost of the letter of credit would be slight compared to the amount of money it represents.[31] This savings to the builder could then be passed on to the purchaser in the form of a lower sales price for the house.

From the lenders' point of view, would they be willing to issue a letter of credit under such an arrangement? The lender should never issue a letter of credit to any builder, or to anyone for that matter, unless it would be willing to lend him money.[32] A lender should be willing to offer this service to a builder who has the requisite credit rating required by the lender.

Since the amount of money the letter of credit represents is so greatly out of proportion to the minimal price for the credit, the lender may require additional security. First, the lender would receive a purchase money security interest in the goods sold to the builder for which the lender pays.[33] Obtaining a security interest in the goods delivered for construction (nails, bricks, lumber, etc.) would be of limited value to the lender, however, because these goods would represent security only until they were incorporated into the house. Upon incorporation, no security interest would exist in such goods under the Uniform Commercial Code.[34] However, such a security interest before the

30. While the lender *may* charge the same price for the loan as that charged for a construction loan, this price is spread out over many small loan amounts depending on the bills presented by the suppliers. Also, the loans are created during the course of construction at varying intervals and not at the beginning of the construction, so most of the loans are open for a shorter period than a construction loan. All this taken together means that the cost of this procedure should be cheaper than that of the construction loan. However, because of the varying costs of construction loans, due to irregular disbursements, and the loans contemplated by the letter of credit procedure, due to the varying lengths of time the individual loans would be open, the price for the amount of money needed should be computed under both approaches and compared to prove the truth of the above statement.

31. The issuer of a letter of credit receives a fee of one-eighth to one-fourth of one percent of the amount paid by the issuer. *See* South Carolina Reporter's Comments, S.C. CODE ANN. § 10.5-109 (1966); Comment, *Recent Extensions in the Use of Commercial Letters of Credit,* 66 YALE L.J. 902, 909 (1957).

32. Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market,* 22 BUS. LAW. 1105 (1967).

33. *See* S.C. CODE ANN. § 10.9-107(b) (1966). A financing statement must be filed to perfect this security interest under S.C. CODE ANN. § 10.9-302(1) (1966). The proper place to file the financing statement is in the office of the Secretary of State of South Carolina. S.C. CODE ANN. § 10.9-401(1)(c) (1966). Such a perfected purchase money security interest is given special treatment in several sections of Article 9. *See* S.C. CODE ANN. § 10.9-312(4) (1966) and S.C. CODE ANN. § 10.9-301(2) (1966).

34. S.C. CODE ANN. § 10.9-313(1) (1966).

goods are actually used could serve as limited security to the lender. Before use, these goods would be security for the amount of the loan created when the lender paid the bills for such goods. If these goods are not actually used, they should be readily resaleable. Also, such an interest would serve as security that the goods would be incorporated into the house, thus enhancing the possibility that the house would be completed and sold. Second, if the bank wanted complete security for their credit, they could require the builder to furnish a completion bond along with his request for a letter of credit. A completion bond obtained from any reputable surety would insure the lender that the house would be completed if the builder were to default in his obligation.[35] Third, the lender could require that it receive the permanent mortgage from the purchaser. The lender knows exactly the amount of money that must be received from the builder to pay off the loans entered into between the lender and the builder. Thus, the lender, by requiring that it receive the permanent financing, can make sure that the house is sold for a purchase price sufficient to cover these outstanding loans. In this way, the lender would be making money in three different ways out of the same transaction: from the cost of the letter of credit issued to the builder; from the cost of the individual loans to the builder; and from the cost of the permanent financing for the purchase of the completed house.

As an alternative to the procedure followed above, another approach could be used which would require the lender to pay out only labor costs unless there was a default by the builder. The builder could request the credit as above, furnishing any one or all of the security devices mentioned. With the credit, the builder would be in a strong financial position to receive credit from his suppliers for the goods delivered and used in construction. Because of this credit—an assurance of payment—the suppliers should be willing to extend credit to the builder for 60, 90, or 120 days, depending upon the estimated time needed for completion of the house. Under this approach, the bills are first submitted to the builder for payment at the end of the credit period. By this time, the house should have been sold so

35. To avoid the sometime high cost of a completion bond, the builder may be able to obtain a letter of credit from another bank to serve the same function as such a bond. Such a credit is generally called a performance letter of credit and is accepted in such circumstances by at least one major bank. Letter from James S. Dunne, Assistant Treasurer, The Chase Manhattan Bank to James W. Logan, Jr., March 12, 1970, on file in the South Carolina Law Review.

that the builder could pay off the bills from the proceeds received from the sale of the house. Under this approach, the lender would only be tying up so much of its capital as is needed to meet the labor costs of the builder. Its credit would be used by the builder to meet the other construction costs, but the bank would not have to pay out any money to the suppliers unless the builder refused payment when these bills were presented to him.[36] Again, such an arrangement should be cheaper than a construction loan. The builder only has to pay the lender for the letter of credit and the loans to cover labor costs, and the suppliers for the short term credit they extended him.

The savings to the builder in the price he has to pay for construction funds should lower the price of the completed structure. Also, such an approach should separate construction costs from rising interest rates so that the increase in such rates will not also automatically mean an increase in construction costs. Thus, housing costs could be leveled off regardless of the fluctuation in the money market.

V. Conclusion

It has been the purpose of this paper to explain the mechanical aspects of the letter of credit device under Article 5 of the Uniform Commercial Code and to give illustrations of its practical uses in domestic transactions. Further, a new use of the letter of credit has been proposed, one which, if practical, could bring some relief to the construction industry which is at a relative standstill because of tight money. It is hoped that understanding of the letter of credit will be increased from this note and that it will be put to its already proven practical uses. Further, it is hoped that the proposal for the use of the letter of credit in the construction industry will be carefully analyzed and studied by both attorneys and lenders. If the letter of credit proposal is found to have merit and can possibly aid in relieving the tight money situation in this hardpressed industry, hopefully it will immediately be put to such use. The letter of

36. The Federal Reserve Board has ruled that a national bank's lending limit margin is not affected by the issuance of a letter of credit, but that margin is narrowed with an acceptance. Thus, a letter of credit is a useful device because the issuing bank's cash is not committed upon its issuance and because such an issuance does not narrow its limit margin. Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market,* 22 Bus. Law. 1105 (1967). *See* 12 U.S.C. § 615 (1945).

credit under the Code is a new animal to South Carolina, but it can be a very useful and beneficial new animal. It deserves your attention.

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