

Letters of Credit

Letters of Credit (“LCs”) are an increasingly common feature of aviation leasing and finance transactions, typically as a cash replacement with respect to security deposits and/or maintenance reserves. It is therefore increasingly important to dispel the sense of opaqueness and inaccessibility with which they can sometimes be associated. The onset of the global pandemic brings this issue sharply into focus: lessors need certainty that, in the absence of cash security, their LC protections remain effective such that they are able to effect drawing as and when required.

This article seeks to address both of the above issues, **firstly** by way of examining LC basic terms and mechanics, key players and relevant contractual principles, and **secondly** by setting out practical considerations and requirements surrounding LCs in a leasing context. We also include some important guidance and a list of action items for LC drawing during COVID-19.

SECTION 1: EXAMINING AN LC

What is an LC?

A letter of credit is a definitive undertaking to pay certain amounts or otherwise deliver an item of value to the beneficiary upon presentation of certain pre-agreed documents (e.g. a draft, a demand certificate and/or a bill of lading).

Why are LCs used?

One of the oldest financial products, LCs originate from the need to pay for goods shipped long distances. The LC mitigates risk by replacing an obligor's credit risk with that of a neutral third party, typically a bank, and replacing that obligor's performance risk by providing for payment solely against delivery of certain pre-agreed documents.

A typical scenario is as follows:

- seller (exporter) and buyer (importer) enter into a contract for the sale of goods;
- seller ideally doesn't want to ship the goods until it is paid; and
- buyer ideally doesn't want to pay until the goods are received and inspected.

Absent some kind of third-party intervention, there is little common ground between buyer and seller.

As a solution, buyer arranges for a third party (usually an internationally recognised bank) to issue an LC in favour of seller. The LC is a unilateral, unconditional obligation of the issuer. When objective events have occurred, solely as evidenced by the presentation of documents to the issuer, the issuer is unconditionally required to pay the designated amount to the seller.

In the context of the requested LC, the parties would assume the following roles:

- the buyer is the "applicant" or "account party" of the LC;
- the bank issuing the LC is the "issuer" or "issuing bank"; and
- the seller is the "beneficiary" of the LC.

Contracts

The above relationships are set out across (at a minimum) three *separate* contracts, as follows:

1. *Underlying contract* (between the applicant and the beneficiary) – this creates the underlying payment obligation that will be supported by the LC. In the illustration above, the underlying contract is a contract for the purchase and sale of goods.
2. *Application/reimbursement documents* (between the applicant and the issuing bank) – these constitute (i) the applicant's request that the issuing bank provide the LC to the beneficiary together with (ii) the applicant's agreement to reimburse the issuing bank for any drawing under the LC and indemnity for any losses that the issuing bank may suffer.
3. *Letter of credit* (issued by the issuing bank in favour of the beneficiary) – this sets forth the issuing bank's unconditional obligation to pay up to a maximum stated amount and up to a final payment deadline (the "expiry date") upon presentation of conforming documents.

LCs function as unilateral contracts – i.e. the issuing bank has only obligations and the beneficiary has only rights. The consideration in favour of the issuing bank is provided solely by way of the application/reimbursement documents. There is no need for consideration to pass from the beneficiary to the issuing bank.

If an issuing bank properly honours a drawing under an LC, it is entitled to reimbursement from the account party pursuant to the application/reimbursement agreement. If it improperly honours a drawing (e.g., it pays against documents that do not comply with the requirements of the LC or at a time when the LC has expired), it is not entitled to reimbursement. Conversely, an issuing bank that improperly dishonours a drawing under an LC can be liable to the beneficiary for breach of contract damages.

Key parties

Advising banks

Banks often assume the role of "advising bank" in LC transactions. An advising bank notifies the beneficiary

that the issuer has issued an LC and of the specific terms of that LC. Although the letter of credit typically appears on the letterhead or other written medium of the advising bank, the advising bank does not in any way engage itself to make payments or otherwise to perform services in connection with the LC and does not guarantee the issuer's performance.

The role of advising bank arose at a time when few banks had international reputations or global communications capabilities. A letter of credit was a physical letter that would be sent by an issuing bank in one state or country to a beneficiary in another. The beneficiary might not even have heard of the name of the issuing bank and had few ways to verify the authenticity of the LC. The advising bank was a bank in the beneficiary's own country that had a relationship with the issuing bank. It could more reliably transmit the text of the LC, and its intervention as advising bank would *de facto* help vouch for the legitimacy of the LC transaction.

Today, the widespread availability of information about banks and of telecommunications makes some of the advising bank's role obsolete, but advising banks still serve a useful function in facilitating the transmission of letters of credit and, at times, the processing of presentations under them, once again without being engaged on the credit.

Confirming banks

Internationally recognised banks also commonly assume the role of confirming bank on LC transactions.

The confirming bank typically is also an advising bank, but unlike an advising bank, it does engage itself on the credit. By doing so, the confirming bank assumes from the issuing bank the primary obligation under the LC, i.e., to pay the beneficiary, upon presentation of documents. It does so with the expectation that, if it properly honours a drawing under the LC, it will be entitled to be reimbursed by the issuing bank (typically pursuant to an inter-bank reimbursement agreement).

The confirming bank has no relationship with, and therefore no claim against, the applicant, but only against the issuing bank which, in turn, relies on the applicant for reimbursement. Like that of the advising bank, the role of the confirming bank arose at a time when

international payment systems were far less developed than they are today. The beneficiary of a letter of credit may not have had a practical way to present documents to the issuing bank in a distant state or country, and even if it could, it may not have wished to suffer the inconvenience of having to remit funds back to the beneficiary's home country. In fact, the beneficiary might have insisted on receiving a letter of credit issued only by a bank in its own jurisdiction. The buyer/applicant, on the other hand, often did not have a relationship with any bank in the seller/beneficiary's state or country. The role of confirming bank was a practical arrangement by which the buyer/applicant could go to its own bank for issuance of an LC, and rely on that bank to utilise its own correspondent banking relationships to find a confirming bank in the seller/beneficiary's home jurisdiction.

Global banking today may have rendered some of the purposes of a confirming bank obsolete, but certainly not all. Many banks that issue letters of credit do not yet have worldwide operations, and certainly not in every country where their customers do business. Beneficiaries of LCs still prefer the convenience of making presentation to a local bank in their own country or even in their own city. Moreover, adding a confirming bank to an LC transaction is an effective way to upgrade the creditworthiness of the LC, especially when the issuer is a bank whose name is not well recognized in the beneficiary's jurisdiction or does not enjoy the highest credit rating.

Basic types of LC

- *Commercial letter of credit* (sometimes called "trade" or "documentary" letter of credit) – this is the 'classic' form of LC, typically providing for payment for purchase of goods or services.
- *Standby letter of credit* – typically backs a purely financial obligation after non-payment by the applicant/obligor, and functions in some ways like a guarantee (noting the independence principle as explained below).
- *Direct pay letter of credit* – this is the same as a standby letter of credit, with the key differences being that (i) it is typically the sole method of payment in favour of the beneficiary and (ii) it doesn't require a default by the applicant/obligor under the obligation that the LC supports.

Commercial letters of credit typically have much smaller stated amounts than standby or direct pay LCs, but paradoxically can be more complex, especially in terms of documents and other requirements for drawing. A standby letter of credit seldom requires presentation of any documents other than a drawing certificate in the requisite form, and sometimes a negotiable draft. By contrast, a commercial letter of credit often requires presentation not only of a draft but also of a bill of lading, insurance certificate, customs declaration and other documents relating to the underlying trade transaction. Those documents eventually should be passed along to the account party, which is the buyer in the trade transaction.

Key principles of LCs

Documentary credit

Perhaps the defining characteristic of an LC is that the issuing bank must pay solely against proper presentation of the correct documents. There is no other mechanism for payment. Save in cases involving fraud, the issuing bank can refuse to honour a drawing request only on the grounds that incomplete or incorrect documents have been presented (or that they have not correctly been presented within a specified timeframe). Following such refusal, the beneficiary may submit a revised request for drawing under the LC, assuming that the LC has not expired (see *Key terms* below).

Independence principle

The contracts in an LC transaction (see *Contracts* above) are separate and independent from one another, and as such the issuing bank must pay the beneficiary upon correct and timely presentation of the required drawing documents regardless of how things stand under the other contracts and regardless of the ability of the applicant to reimburse the issuing bank for the drawing. New York law recognizes only a few exceptions to this principle, primarily relating to fraud or forgery.

As an extension of the independence principle, insolvency of the applicant would not serve to disrupt a drawing under the LC. The generally agreed position is that payments made by the issuing bank are paid out of the bank's own funds and should not be deemed to have been made on behalf of the applicant. Those payments

therefore would not be treated as part of insolvent applicant's estate (and subject to clawback). It should however be noted that US case law provides an example to the contrary, but that case has largely been discredited.

Banks take the independence principle very seriously, as it is fundamental to the reliability (and therefore commercial desirability) of LCs. Issuing banks have been known to insist on honouring properly submitted drawing requests even when they know they are unlikely to be reimbursed.

Customs and Practice

Most LCs are issued and formatted under the guidelines of either of the two leading publications issued by the International Chamber of Commerce: the Uniform Customs & Practice for Documentary Credits, known as the UCP600, or the International Standby Practices, known as ISP98. The former is more customary for commercial letters of credit and the latter was designed for standby letters of credit, but either of them may be selected by the parties. Letters of credit typically state that they are subject to one of those two publications.

Many market participants assume that UCP600 and ISP98 are bodies of law, and indeed, that they are the laws that govern the LC, but in fact they are not. They are a written body of custom and practice that issuers use to set expectations as to administrative processes and the scope of their responsibilities. They are terms that supplement the typically spare provisions of the LC. By selecting UCP600 or ISP98 to apply to an LC, it is as if the issuing bank had appended those publications to the LC as additional text.

Basic terms

LCs will almost always contain the following basic terms:

- Date
- LC Number
- Name and address of issuing bank
- Identity of applicant
- Identity of beneficiary
- Maximum amount (and currency)
- Drawing requirements
- Confirmation as revocable/irrevocable status
- Confirmation as to assignability or transferability
- Expiry date

Somewhat surprisingly, LCs do not always provide for a governing law. Many banks assume that the law of the jurisdiction of the office that issues the letter of credit will apply, and indeed applicable statutory or common law may in the end hold that this is the case. In our view, however, it is far better to specify the governing law so that this issue does not become the subject of litigation. Once again, UCP600 and ISP98 provide important terms and conditions applicable to an LC, but they are not the governing law.

Key terms

The last four terms listed above require particular attention:

Drawing requirements

These are solely determinative as to the beneficiary's drawing ability, so it is of paramount importance that they are (1) within the beneficiary's control and (2) clearly set out, without any scope for ambiguity.

Typically, the following requirements will be specified:

- Specification of documents to be presented (e.g. bill of lading, insurance certificate);
- Manner of presentation of documents (e.g. physical presentation of originals at specific address within a specific timeframe); and
- Other trigger events, e.g. payment has become due under a financial instrument or event of default has occurred under a lease.

In practice, it also is possible (although uncommon) that the issuing or confirming bank may impose further administrative requirements at drawdown. For example, upon presentation the issuing or confirming bank may insist on evidence that certain documents have been signed by a duly authorised signatory, even where such condition is not explicitly listed in the LC.

The documents presented under the LC typically are passed along to the applicant in connection with the applicant's reimbursement obligations and may be important to the applicant's commercial relationships with its contract counterparty (i.e., the beneficiary). For example, if the applicant believes that the beneficiary

drew under the LC at a time when it was not authorized to do so under the principal contract, statements made by the beneficiary in its drawing certificate and defects in the trade documents presented under the LC may be key elements of the applicant's claims against the beneficiary.

For that reason, applicants need to be sure that the terms on which the LC is stated to be drawn contain the statements and information that the applicant may need to substantiate its claims against the beneficiary. At the same time, the beneficiary is motivated to insist on an LC whose text makes it as simple as possible to draw and receive payment.

See also the "*Drawing during COVID-19*" section further below.

Revocable/Irrevocable status

At least in theory, a letter of credit can be issued as a revocable agreement, but as a practical matter that would defeat the commercial purpose for which it is used. Nonetheless, beneficiaries should make sure that all LCs on which they intend to rely are clearly stated to be "Irrevocable" and contain no text to the contrary.

Assignability and Transferability

Assignment of a letter of credit means that the proceeds of any drawing have been assigned to a third party. The original beneficiary remains the sole person with rights to draw under the LC.

Transferability of a letter of credit means that a third party is substituted for the original beneficiary as the person entitled to draw. Transferability is particularly important for standby LCs whereby the beneficiary has a foreseeable need to transfer its interest in the underlying contract (see *LCs in the context of a lease* below). A letter of credit is considered to be non-transferable unless it expressly states that it may be transferred. Transferrable letters of credit frequently set forth a procedure for transfer, which involves the presentation of an agreed form of transfer instrument. For administrative ease, after the effectiveness of a transfer the issuing bank may wish to issue a new LC in favour of the transferee in exchange for the original LC.

Maximum stated amount/Expiry date

Bank supervisory authorities are keen for banks not to incur contingent liabilities that are unlimited in amount or duration, so nearly all letters of credit are written with a maximum amount that can be drawn, and if stated to be irrevocable, are stated to expire automatically either upon a designated expiry date or upon return of the LC to the issuer for cancellation. New York UCC 5-106(c) deems all letters of credit to expire within one year after issuance if they do not have a stated expiry date.

A notable exception to the maximum stated amount principle appears in standby letters of credit backing bond issuances. Those LCs sometimes contain a feature by which the stated amount of the LC is divided into a principal component and an interest component. The principal component can be drawn by the bond trustee only to pay the principal of the bonds, and that component of the LC is a fixed amount that reduces with each drawing. The interest component can be drawn at any time when an interest coupon on the bonds becomes due. If that drawing is reimbursed by the applicant, the interest component is reinstated.

“Evergreen” letters of credit typically have a one-year expiry date that is automatically extended at the end of their term for an additional one-year period unless the issuer sends notice of non-extension within an agreed number of days prior to expiry. Evergreen clauses usually provide that, upon failure of the issuing bank to extend the term of the LC, the beneficiary may draw the full amount of the LC whether or not amounts are owed to it under the underlying contract. The applicant, of course, hopes to find another bank to issue a replacement LC before that drawing happens.

Procedures

The bank receiving documents has a reasonable time to examine them before honouring or dishonouring them. If the issuing bank (or, as the case may be, the confirming bank) refuses to honour a drawing request, UCC 5-108(b) provides that it must notify the beneficiary within a reasonable time, and provides for a safe harbour of 7 business days. UCP 600, for example, provides that such notice must be provided within 5 banking days. In any case, reasonableness will be determined in accordance

with complexity of LC and drawing documents.

Sources of law

- Letters of credit are contracts, and like any other contract, are subject to interpretation and enforcement by reference to common law.
- UCC Article 5 – In addition, in the United States, letters of credit are governed by Article 5 of the Uniform Commercial Code and its related judicial interpretations.
- As noted above, letters of credit often incorporate either UCP600 or ISP98 into their terms, but these terms do not constitute a governing body of law.
- United Nations Convention on Independent Guarantees and Standby Letters of Credit also may be applicable.

A survey of laws around the world is beyond the scope of this memorandum, but scholars have noted a remarkable uniformity of law and practice worldwide relating to letters of credit.

SECTION 2: LCs IN A LEASING CONTEXT

Aircraft leases commonly allow for the lessee to provide a standby letter of credit in favour of the lessor as a substitute for its payment obligations in respect of a security deposit and/or maintenance reserves.

Although the lessee will have to pay the application fee for such an LC, the conversion of cash deposits would free up valuable working capital and thereby represent a significant overall benefit for the lessee.

Conversely, the lessor's security package is arguably weakened by the substitution for an LC, but the lessor can exert a degree of control over this process by setting the minimum credit rating that an issuing bank (and/or confirming bank) must meet, together with certain other requirements.

Typical Lessor requirements

A common list of minimum lessor requirements for an LC is as follows:

- First demand, irrevocable and absolute payment undertaking of the issuing bank;
- Denominated in US dollars;
- Payable on written demand without proof or evidence of entitlement or loss required;
- Presentable at certain specified offices of the issuing bank (these would typically include locations that are practicable for the lessor);
- Issued and payable by a major international bank acceptable to the Lessor with a long-term unsecured rating of "A3" or better from Moody's or "A-" or better from Standard & Poor's; and
- Non-cancellable for a minimum 12-month term (some lessors may require automatic renewal).

It should also be noted that LCs are issued in amounts ranging from hundreds of thousands to millions of dollars, so their relative importance in the context of a lease will vary accordingly.

Transferability risk

A new lessor stepping into an existing lease will want any corresponding LC assigned/transferred in its favour as soon as possible following the effective time under the

relevant lease novation agreement (the "Effective Time") (but never at or before the effective time).

As stated above, transfer mechanics are dictated by the relevant issuing bank, and will either involve assigning, transferring or replacing the existing LC (in favour of existing lessor) such that it is in favour of new lessor. The time periods for completing this process can vary significantly, ranging from 1-2 business days to 90 business days (and in some unusual cases even longer), depending on the jurisdiction of the issuing bank (or, as applicable, the confirming bank). Therefore, regardless of the specific transfer mechanics, new lessors will always have a period of "exposure", during which they are not the beneficiary of record under the LC and therefore cannot effect drawing thereunder.

In practice, the following solutions are commonly used to avoid/mitigate transferability risk:

Holdback amount

New lessor/buyer can withhold the value of the LC from the purchase price in respect of the underlying asset(s), with such amount to subsequently be paid to the existing lessor/seller upon successful completion of the LC transfer.

This is a simple and clean solution, which both removes new lessor/buyer exposure and also incentivises the existing lessor/seller to actively manage the LC transfer process after it has disposed of its interest in the underlying asset(s). However, since it notably allocates all transfer risk to the existing lessor/seller, it may not be a realistic option in every case.

Non-operative replacement LC

Certain issuing banks can issue a replacement LC in advance of the Effective Time containing "non-operative" language. By this effect, the replacement LC will take effect only after the Effective Time upon satisfaction of certain conditions, for example receipt by the issuing of the original existing LC. The new lessor should require conditions subsequent undertakings from the existing lessor/seller to satisfy any relevant conditions within its control. From a practical perspective, it might also make sense to pre-position certain original documents with the relevant parties for the purposes of effecting replacement

as quickly as possible following the Effective Time.

Existing lessor undertaking to draw

Absent the above options, the new lessor/buyer's next best option would be to rely on the existing lessor/seller as (temporary) beneficiary of record to effect drawing under the LC following an event of default under the novated lease.

This would be achieved by way of an undertaking from the existing lessor/seller to (i) draw on the LC, (ii) hold the proceeds on trust for the new lessor/buyer and (iii) transfer the same to the new lessor/buyer as soon as possible following receipt.

Drawing during COVID-19

As noted in the "Drawing requirements" section above, the process for drawing under LCs is highly prescriptive at the best of times. In the context of a global pandemic that brings with it empty offices and restricted travel, the process is made even more complex and challenging, but not by any means impossible. Here are some practical tips to bear in mind in order to successfully effect drawdown:

Confirming the bank's position

The contact details for the issuing bank (or confirming bank as applicable) will be set out in the text of the LC. We recommend contacting them as many times as necessary to secure a confirmation as to whether (and if so, how) their LC drawing protocol has changed during COVID-19.

Submitting the drawing request

In view of the highly prescriptive drawing process, we would advise that submission of the drawdown request and all accompanying original documents should be made in person wherever possible. Sending by post/courier increases the risk of originals going missing, which could have the effect of scuppering the drawdown process entirely.

We would also advise that such submissions are made as far in advance of the LC expiry date as possible – on account of the possibility that re-submissions will need to be made.

When making the submission in person, it is vital to keep a record of:

- (i) The date and time of submission;
- (ii) The name of the person receiving and signing for the documents; and
- (iii) Confirmation from the recipient that they will immediately transfer the documents to the relevant department within the bank for processing.

Confirmation of submission

Immediately post-submission of the drawing request, a confirmation email should be sent to the bank (with the beneficiary also copied) setting out the submission details as identified above.

Thereafter, the process will require active management in terms of requesting status updates from the bank.

Rejected submissions

Should the application for drawing be rejected, the immediate action points will be:

- (i) To confirm the precise reason(s) for such rejection. If this is achieved by way of email, the submission reference as provided by the bank will need to be quoted;
- (ii) To confirm the location of all original documents as submitted to the bank; and
- (iii) To confirm that all such original documents will either be returned to the beneficiary or held by the bank.

Thereafter, when making any further submission(s) the above requirements relating to records of submission, confirmation email and status updates will again apply.

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