What law governs letters of credit?

Note: Letters of credit are used in (1) trade of goods , (2) as a security for other types of obligations including those arising from, (a) loan agreements, (b) contracts for the supply of services or (c) construction of buildings and infrastructures (AQUINO, Notes and Cases in Banking Law and Negotiable Instruments Law Vol. 1 (2009) p. 497) [hereinafter AQUINO , Negotiable Instruments ].

What is a letter of credit?

A letter of credit is an engagement by a bank or other person made at the request of a customer that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit (Prudential Bank v. IAC, 1992)

What is the nature of a letter of Credit?

The uniform Customs and Practice for Docummentary Credits (UCP) governs letters of credit. Although the provisions of the Code of Comemerce on letters of credit were not repealed by the Civil Code or any other Special Law, its provisions are already rendered absolete by the present cutoms on letters of Credit (AQUINO, Negotiatable Instruments, p. 500).

What is the nature of a letter of credits?

The following are the factors to be considered:
01. The relationship between the beneficiary and the issuer of a letter of credit is not strictly contractual because both privity and meeting of the minds are lacking, yet strict compliance with its terms is an enforceable right.
02.Nor is it a third-party beneficiary contract because the issuer must honor drafts drawn against a letter regardless of problems subsequently arising in the underlying contract. Since the bank's costumer canot draw on the letter, it does not function as an assignment by the costumer to the eneficiary.
03. Nor, if properly used, is ot a contract of suretyship or guarantee, because it entails a primary liability following a default.
04. Finally, it is not in itself a negotiable instrument, because it is not payable to order or to bearer and is generally conditional, yet the draft presented under it is often negotiable (AQUINO, Negotiable Instruments, p. 498).

What is the purpose of a letter of credits?

It is for the redction of the risk of nonpayment of the purchase price under the contract for the sale of goods . It is a financial device developed to satisfy the seemingly irreconcible interest of a seller , who refuses to part with his goods before he is paid , and a buyer who wants to have control the goods before paying (Bank of America v. Court of Appeals, G.R. No. 105395, December 10, 1993)

Who are the parties to a letter of credits?

Thre should at least be three (3) parties to a letter of credits : (BBaS)
1. The Buyer, who procures the letter of credits;
2. The Bank who issues the letter of credits; and
3.The seller

Note: The number of parties, not frequently and almost invariably in international trade practice , may increased (AQUINO , Negotiable instruments supraat 502) . Thus,there may have additional parties in a letter of credit like the notifying bank, the negotiating bank and the paying bank ( Charles Lee, et al , v Court of Appeals et al., G.R No. 117923, February 1, 2002).

What is the obligations of buyer?

The buyer obliges himself to reimburse issuing bank upon receipt of the documents of tittle (AQUINO, Negiotable Intruments supra at 502)

What are the obligations of the bank issuing the letter of credits?

The obligation of the issuing bank are the following:(PEN)
1. To make a Payment to or to the order of the third party (the beneficiary) or to accept and pay the bills of exchange drawn by the beneficiary;
2. To authorize another bank to Effect such payment, or to accept and pay such bill of exchange; or
3. To authorize another bank Negotiate , against stipulated documents, provided that the terms and conditions of the Credit are complied with (AQUINO , Negotiable Instruments supre at 503).

What are the obligations of the seller ?

In compliance with the contract of sale, the seller shall ship the goods to the buyer and deliver the documents of tittle and draft to the issuing bank or confirming bank to recover payment (AQUINO, Negotiable Instruments supra at 502,506).

What are the three distinct and independent contracts in a letter of credit?

In a letter three distinct and independent contracts: (BS-BBa-BaS)
1. The contract of sale between the Buyer and the Seller,
2. The contract of the Buyer with the issuing Bank, and
3. The letter of credit proper in which the Bank promises to pay the seller pursuant to the term and conditions stated therein (AQUINO, Negotiable Instruments supra at 509)

What is the Doctrine of Independence?

The Independence principle of a letter of a credit emphasizes that the contracts involved in a letter of a credit arrangement are to be maintained in a state of perpetual separation ( Keng Hua Paper Products Co., Inc. v. CA, G.R. No. 116863, 1998). By the independence principle, the bank determines compliance with the letter of credit only y examining the shipping documents presented; it is precluded from determining whether the main contract is actually accomplished or not (Bank of America, NT & SA v. CA, G.R No. 120135, 2003). The letter of credit is independent not only of the contract between the seller and the buyer but also of the credit agreement between the buyer and the issuing bank.The contract between the two has no bearing as to the non-compliance by th buyer with the agreement between the latter and the seller (Feati Bank and Trust Co. v. CA, G.R No. 94209, 1991).

What are the two concepts of the Doctrine of Independence?

The two (2) concepts of the doctrine of independence are as folows:(TJ)
1. Independence in Toto where the credit is independent from the justification aspect and is a separate obligation from the underlying agreement like for instance a typical standy; and
Note: Typical Standby Letter of Credit - security arrangement for the performance of certain obligations. It can e drawn against if only another bussiness transaction is not performed. It may be issued in lieu of a performance bond (Black's Law Dictonary, 6th Ed., p. 904).
2. Independence as to the Justification aspect, like in a commercial letter of a credit or payment standby, which is identical with the same obligations under the underlying agreement.
Note: Commercial or payment Standby - supports the oligations of an applicant to pay for goods or services in the event of non-payment y other methods.

Note: In both cases, the payment may be enjoined if in the light of the purpose of the credit, the payment of the credit would constitute fraudulent abuse of the credit (Transfield Philippines, Inc. v. Luzon Hydro Corporation, G.R. No. 146717, 2004).

Who can invoke the independence principle?

The following can invoke the independence principle:
01. The issuing bank; and
02. The beneficiary (AQUINO, Negotiable Instruments, p. 514).

05/ ABC Company filed a Petition for Rehabilitation with the Court. An Order was issued by the court, (1) staying enforcement of all claims, whether money or otherwise against ABC Company, its guarantors and sureties not solidarily liable with the company; and (2) prohibiting ABC Company from making payments of its liabilities, outsiding as of the date of the filling of the Petition. XYC Company is a holder o an irrevocable Standy Letter of Credit which was previously procured by ABC Company in favor of XYC Company to secure performance of certain obligations. In light of the order issued by the court, can XYC Company still be able to draw on their irrevocable Standby Letter of Credit when due? Explain your answer (2012 Bar)

Yes. Under the first concept of the Independence Principle of a letter of a credit in independent from the justification aspect and is a separate obligation from the underlying agreement lke for instance a typical standby. Thus, though there was a suspension of payments of claims, the letter of credit is independent and a separate obligation for the ABC Company.

What is the fraud exception principle?

This is an exception to the independence principle. "Fraud exception" exist when the beneficiary , for the pupose of drawing on the credit, fraudently present to the confirming bank, documents that contain, expressly or or by implication, material reprentations of fact that to his knowledge are untrue. The untruthfulness of a certificate accompanying a demand for payment under a standby credits may qualify as fraud sufficient to support an injunction againts against payment (Trnsfield Philippines, Inc v. Luzon Hydro Corporation, G.R. No. 146717, November 22, 2004).

 Bravo Bank received from Cisco Bank by registered mail an irrevocable letter of credit issued by Delta Bank for the account of Y Company inthe amount of US$10,000,000 to recover the sale of canned fruit juices. The beneficiary of the letter of credit was X Corporation which later on partially availed itself of the letter of creditby submitting to Bravo Bank all documents relative to the shipmentof the cans of fruit juices. Bravo bank paid X Corporation for its partial availment. Later, however, it refused further availment because of suspicions of fraud being practiced upon it and, instead, sued X Corporation to recover what it had paid the latter. How would you rule if you were the judge to decide the controvesy? (2003 Bar)

Bravo Bank, which is the paying bank, can defer its payment to X Corporation, the seller. Under the second concept of the independce principle of letters of credit, payment maybe be enjoined if in the light of the purpose of the credit, the payment of credit would institute as fraudulent abuse of credit. Moreover, under the fraud exception against payment. However, Bravo Bank cannot sue the seller. Instead, Bravo Bank should sue the buyer as the latter has the obligation to reimburse the bank whatever it has paid to the seller.

What is the doctrine of strict compliance?

The doctrine of strict compliace provides that the documents tendered by the seller or beneficiary must strictly conform to the terms of the Letter of Credit (i.e. they must include all the documents required by the Letter of the Credit). A correspondent bank which departs from what has been stipulated under the letter of credit, as when it accepts a faulty tender, acts on its own risks and it may not thereafter be able to recover from the buyer or the issuing bank, as tne case may be, the money thuis paid the beneficiary (Feati Bank v. CA, G.R. No. 94209, April 30, 1991)