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The Risks and Rewards of Issuing Standby Letters of Credit

By Eric G. Baron, Aldrich & Bonnefin, PLC

In the past, letter of credit transactions were the domain of large money-center banks, but today more and more small independent banks are asked to issue letters of credit for their clients. Many institutions are issuing standby letters of credit (Standby) to accommodate their customers, but also because letters of credit represent a good source of fee income. Unfortunately, many institutions will issue standby letters of credit without fully understanding how the letter of credit works and the rules that govern them. This article will explore the risks and rewards that may arise when issuing a Standby.

In its simplest terms, a Standby is an undertaking or commitment by the issuer of the Standby, made at the request of the applicant, to pay to the named beneficiary a stipulated amount provided the beneficiary satisfies certain documentary conditions. Generally, a Standby is established to provide assurance to the beneficiary that the applicant will perform certain obligations arising out of a separate transaction between the beneficiary and applicant. These obligations might be the satisfactory performance of a service or delivery of a product, full performance under a contract, or the payment of money. Whereas the beneficiary's right to payment under a commercial letter of credit depends on the performance or non-performance by the beneficiary, the beneficiary's right to payment under a Standby depends on the performance or non-performance of the applicant.

A Standby is issued at the request of an applicant. The application for Standby is part of the contract or agreement between the applicant and the issuer. It provides the issuer with the basic information that the issuer needs to create the Standby (e.g., the name of the beneficiary, the amount, and the term of the letter of credit). More importantly, the application includes instructions by the applicant to the issuer with regard to the circumstances under which the letter of credit is to be paid (i.e., the conditions to payment). The issuer must be able to translate these instructions into conditions or requirements of presentment set out in the Standby.

Before an issuer accepts a Standby application, the issuer must confirm that the applicant's instructions are clear and can be easily followed. If the applicant's instructions are unclear and the issuer fails to follow the instructions, the applicant may have a defense to reimbursement. Issuers should avoid being placed in a position of issuing a Standby for the account of an applicant that is attempting to change or amend the underlying agreement with the beneficiary by requiring complex conditions to payment under the letter of credit.

One of the most important terms provided by an applicant in an application for a Standby will be the condition or conditions to honoring a draw on the letter of credit. It is important that the applicant precisely describe the conditions under which it expects the issuer to honor a Standby.

In order to avoid any duty or implied duty by the issuer to analyze or interpret information, the conditions required by the application (and letter of credit) generally should include only the presentation of a draft together with a certified statement, signed by an authorized officer or representative of the beneficiary, stating that the beneficiary is entitled to payment and the basis for such entitlement. In order to avoid the need to evaluate or assess whether a certified statement meets the requirements set forth in the application and Standby, the issuer should require that the applicant provide specific language for the certified statement to be provided by the beneficiary in connection with a draw on the letter of credit.

A crucial document in a Standby transaction is the reimbursement or letter of credit agreement. Generally, it is this document that establishes the applicant's contractual obligation to reimburse the issuer for any payments made under the Standby. In addition, the reimbursement or letter of credit agreement should provide other important terms with respect to reimbursement.

Some issuers have the applicant execute a promissory note in the amount of the Standby as evidence of the applicant's reimbursement obligation. The note would contain some of the terms outlined above with regard to timing of reimbursement and interest on the reimbursement amount. If the issuer elects to use a promissory note to evidence the obligation, reference to the note should be made in the reimbursement or letter of credit agreement that also should be signed by the applicant. Otherwise, the issuer will have the burden of establishing the connection between the note and the letter of credit transaction.

If handled properly, issuing a Standby will not only provide an institution's client with an important service, but should provide the issuing institution with a good source of fee income. On the other hand, if not handled carefully, the issuing institution may find itself embroiled in a dispute between the applicant and the beneficiary. The key to success when issuing a Standby is to fully understand the issues that may present themselves during the transaction as well as fully understand the rights and obligations of parties to the transaction.

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Eric Baron is a principal with Aldrich & Bonnefin, PLC (www.ablawyers.com). He can be reached at 949-474-1944 or ebaron@ablawyers.com.