We Have Seen the Future and It is ISP98: The Evolution of Letters of Credit for Municipal Purposes

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Introduction

Whether it is a tribute to our excellent banking system or whether it is by good luck, letters of credit rarely show up on the "hot issues radar" of municipalities. Collectively, municipalities in Canada are the holders of letters of credit worth hundreds of millions of dollars.[1] Yet, there is little discussion of these documents in municipal circles. The "squeaky wheel syndrome" does not apply to letters of credit for municipal purposes because they do what they are supposed to do: provide security for future obligations by third parties. The purpose of this paper is to argue that municipalities should be wary of adopting the new international standard for standby letters of credit, which is known as International Standby Practices- ISP98 ("ISP98").[2]

Origin of Letters of Credit

Merchants developed letters of credit over the last 300 years as a method of payment of goods in international trade.[3] Letters of credit allowed a seller, unwilling to rely upon the promise of a buyer in another country to pay for goods once the goods were shipped to the buyer, to be assured that the seller could obtain payment once the goods were loaded on vessels. The seller would present the agreed shipping documents to the bank which had undertaken to make payment to the seller independent of the contract

between the seller and the buyer.[4] This document therefore greatly enhanced international trade because there was a reliable means of securing payment from a foreign buyer.

The letter of credit involves a three-party relationship in a commercial transaction. There is an underlying contract between the applicant (buyer) and the beneficiary (seller) pursuant to which the applicant is obligated to obtain credit for the benefit of the beneficiary. There is another contract between the applicant and the person whom the applicant asks to issue the credit, known as the issuer (financial institution). The third contract is between the issuer and the beneficiary whereby the issuer undertakes to honour a presentation for payment by the beneficiary. This undertaking is primary and must be honoured without any claim, counterclaim, setoff or defence that the issuer or applicant may have against the beneficiary.[5] A letter of credit is an offer by the issuer that can be taken up by the beneficiary when he or she is entitled to do so.[6]

Documentary and Standby Credits

There are two types of letters of credit: documentary and standby. The main difference between documentary and standby credits is the purpose of such credits: a documentary credit is a payment mechanism while a standby credit is usually a guarantee mechanism.[7] With a documentary letter of credit, also referred to as a commercial letter of credit, there is an expectation by the parties (buyer and seller) that the letter of credit will be cashed upon all conditions being met by the seller. With a standby letter of credit, the expectation of the parties is that the letter of credit acts as a guarantee to ensure the

performance of obligations by one of the parties and that the letter of credit will only be cashed should there be non-performance of those obligations.

Common to both types of credit is that the issuer undertakes to pay against a specific document or documents that accompany a request for payment. Such payment can be made at the time of presentation, which is known as “at sight”, or at a later date, known as “deferred payment”. A documentary credit specifies the documents that must accompany the presentation, such as an invoice, bill of lading and insurance certificate. With a standby credit, the presentation may or may not require documentation and may be a simple demand, as specified in the credit, for payment to the issuer.[8]

Historically, the law that developed and the rules adopted by merchants dealt primarily with documentary letters of credit. Standby letters of credit originated in the United States as a result of legislation which prohibited banks in that country from issuing guarantees. In Canada, the use of standby credits is very recent.[9] Standby credits are used to support payment, when due or after default, of obligations based on money loaned or advanced, or upon the occurrence or non-occurrence of another contingency.[10] A standby letter of credit will obligate the issuer to pay drafts or any demand for payment by the beneficiary only upon the default of the applicant to execute his or her obligations under the underlying contract.[11]

There are three significant differences between documentary and standby credits. Firstly, documentary credits involve the payment of money under a contract of sale.

With a standby credit, the credit is payable upon certification of a party's non-performance of the contract. Secondly, the issuer of a documentary credit expects to pay the seller's drafts. The issuer of a standby credit usually does not expect to pay and the presentation of drafts or demands is an indication that something has gone wrong. Thirdly, documentary credits tend to follow a pattern of the same documents accompanying the presentation, case after case, whereas a standby credit situation can arise out of any number of transactions and the documents could be unique.[12]

Principle of Autonomy

The most important feature of a letter of credit is its autonomy. In *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd*[13] a case involving a contract between a British firm and Libyan purchasers, Lord Denning M.R. stated that:

> "It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between buyer and seller must be settled between themselves. The bank must honour the credit…"[14]

This principle was clearly set out in the leading case in Canada dealing with letters of credit, *Angelica-Whitewear Ltd. v. Bank of Nova Scotia*.[15] This case involved a claim by the applicant against the issuer of a letter of credit to recover an amount debited to the applicant's account for the payment of a draft under a documentary letter of credit. The issues arising out of this case dealt with consideration of the fraud exception to the autonomy principle and the requirement of strict documentary compliance with the terms and conditions of a credit. Mr. Justice Ledain, writing for the court, stated that:

> "The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy

> is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued. Disputes between the parties to the underlying contract concerning its performance cannot as a general rule justify a refusal by an issuing bank to honour a draft which is accompanied by apparently conforming documents. This principle is referred to as the autonomy of documentary credits."[16]

LeDain's statement is a statement of the fundamental principle, referred to as the autonomy principle, governing all letters of credit.[17] The autonomy principle is particularly important for standby letters of credit. In a guarantee situation, the liability of a guarantor to repay a debt does not arise until the existence of the debt is proven and the liability of the guarantor may be reduced by the misconduct of the creditor vis-à-vis the debtor.[18] An important feature of a standby letter of credit is that while it acts like a guarantee, it is independent of the applicant's obligations to the beneficiary and the beneficiary does not first have to demand payment from the applicant before the beneficiary seeks payment from the issuer. The essential characteristics of a standby credit are that the obligation is secondary and depends on the customer's default and payment flows from the presentation of the required documents, independent from and without proof of the underlying facts.[19]

There are exceptions to the autonomy principle that include forgery, duress, public policy considerations and fraud, which is the major exception to the principle of autonomy.[20] Again, in *Angelica-Whitewear*, and followed in other cases,[21] the court stated that the test was whether the "fraud was so established to the knowledge of the issuer before payment of the draft as to make the fraud clear or obvious to the issuer."[22]

Strict Compliance

Another important rule governing letters of credit is the strict documentary compliance rule. That is, documents must appear on their face, upon reasonably careful examination, to be in accordance with the terms and conditions of the letter of credit. However, *Angelica-Whitewear* held that there must be some latitude for minor variations that are not sufficiently material to justify a refusal of payment.[23] Although the court in the *Angelica-Whitewear* case was referring to documentary letters of credit, municipalities should be concerned with this rule when dealing with standby letters of credit. Not that municipalities would not comply with this rule but rather that this rule should not be a barrier or obstacle to a drawing by a municipality for an uncomplicated matter such as a default of the obligations of a developer under a subdivision agreement.

UCP 500

In international trade, which is the arena for letters of credit, security held by municipalities in the form of letters of credit, is not even acknowledged. Prior to ISP98, the international standard for rules governing letters of credit was the Uniform Customs and Practices for Documentary Credits ("UCP") and was drafted and adopted to regulate documentary letters of credit for commercial transactions. The first version of UCP was in 1985 and was known as UCP 400, which itself was revised in 1993.[24] The current version of UCP is known as UCP 500, effective January 1, 1994.[25] and is issued by the International Chamber of Commerce. Very few Canadian municipalities surveyed made their letter of credit subject to UPC 500.[26] Although the introduction to UCP states that the "UCP 500 is the world standard for managing Documentary and Standby Letters of

Credit…" many of the provisions of UCP are either inapplicable or inappropriate for standby credits.[27] For example, Article 1 of UCP 500 provides that it applies "to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit) where they are incorporated into the text of the Credit".

ISP98

As a result of deficiencies in UCP 500 relating to standby credits, a new set of rules dealing specifically with standby letters of credit were adopted. Over a five-year period, a working group, under the auspices of the Institute of International Banking Law & Practice, Inc., drafted rules for standby letters of credit, which were endorsed by the International Chamber of Commerce.[28] These rules are known as International Standby Practices (ISP98) and became effective on January 1, 1999. ISP98 incorporates generally accepted practice, custom and usage of standby letters of credit.[29] Unlike UCP 500, which has 49 articles, ISP98 has ten rules, divided into a number of sections and clauses. ISP98 attempts to provide clear and fair rules for dealing with standby credits.

The Rules are arranged as follows:

Rule 1: General Provisions
Rule 2: Obligations
Rule 3: Presentation
Rule 4: Examination
Rule 5: Notice, Preclusion, and Disposition of Documents
Rule 6: Transfer, Assignment, and Transfer by Operation of Law
Rule 7: Cancellation
Rule 8: Reimbursement Obligations
Rule 9: Timing
Rule 10: Syndication/Participation

A number of these Rules would be of assistance to municipalities when they are dealing with standby letters of credit. They clarify, expand and otherwise set out the rights and obligations of the applicant, issuer and beneficiary. For example, Rule 1 provides that "these Rules are intended to be applied to standby letters of credit (including performance, financial and direct pay standby letters of credit)."[30] As well, an undertaking subject to these Rules is hereinafter referred to as a "standby".[31]

Most letters of credit accepted by municipalities state that they are irrevocable. Rule 1.06(a) provides that a standby is irrevocable and need not so state. Likewise, because the standby is irrevocable, it cannot be amended or cancelled by the issuer except as provided in the standby or as consented to by the person against whom the amendment or cancellation asserted.[32] An important clause in the Rules reflects the autonomy principle and is set out as follows:

> "Because a standby is independent, the enforceability of an issuer's obligations under a standby does not depend on:
>
> i. the issuer's right or ability to obtain reimbursement from the applicant;
> ii. the beneficiary's right to obtain payment from the applicant;
> iii. a reference in the standby to any reimbursement agreement or underlying transaction; or
> iv. the issuer's knowledge of performance or breach of any reimbursement agreement or underlying transaction."[33]

Rule 2.01(a) provides that an issuer undertakes to the beneficiary to honour a presentation that appears on its face to comply with the terms and conditions of the standby in accordance with these Rules supplemented by standard standby practice. Rule 2.06(a) states that "if a standby expressly states that it is subject to "automatic amendment" by an increase or decrease in the amount available, an extension of the

expiration date, or the like, the amendment is effective automatically without any further notification or consent beyond that expressly provided for in the standby. (Such an amendment may also be referred to as becoming effective "without amendment".)".

Presentation, as defined in section 1.09(a) of ISP98, means either the act of delivering documents for examination under a standby or the documents so delivered. There are fourteen sections under Rule 3 governing the simple act of presentation. Likewise, Rule 4, which deals with the examination of the documents that have been submitted as part of the presentation and compliance with the terms and conditions of the standby, has twenty-one sections. These are detailed rules for examining the documents presented for payment for inconsistency,[34] required signature on a document,[35] formality of statements in documents,[36] standby document types,[37] and similar matters. Rule 6 deals with transfer, assignment and transfer by operation of law of standby credits and again sets out very specific rules for transfers and assignments.

The Rules contained in ISP98 are consistent with the law relating to letters of credit as it exists in Canada in significant areas such as the independence of the letter of credit, the autonomy principle, the strict documentary compliance rule and presentation. While there are many well-written rules that govern standby letters of credit in ISP98, and no doubt provide immeasurable guidance to the applicant, issuer and beneficiary of standby credits, there are rules that that could be problematic or unnecessarily complex for municipalities. The question that must be asked is whether municipalities should accept both the benefit and burden of ISP98 with respect to standby letters of credit held

by them. While rules governing the irrevocability of standby credits,[38] the autonomy of the letter of credit[39] and time limits for notice of dishonour of a standby credit by the issuer,[40] would be of assistance to a beneficiary of a letter of credit, there are other rules that should concern beneficiaries.

For example, Rule 4.15(a) provides that a presented document must be an original. However, in the case of *GAN General Insurance Co. v, National Bank of Canada,*[41] the Ontario Court of Appeal held that the presentation of a true copy of a letter of credit, instead of the original, was not sufficiently material to justify a refusal of payment. This, despite the fact that presentation of the original letter of credit was an express term of the letter of credit. The court further held that the issuer was only entitled to "substantive", not strict compliance with respect to the term requiring the original letter of credit. Rule 4.09 states that if a standby requires specified wording by the use of quotation marks and if the standby also provides that the words "exact" or "identical" are used, then the standby credit presented must be the mirror image of the standby that was issued. This means that typographical errors in spelling, punctuation and spacing, as well as blank lines must be exactly reproduced.

Unless municipalities conduct a line-by-line examination of ISP98 to determine the effect of each rule on a municipality's ability to draw upon a letter of credit, they should not be too eager to embrace ISP98. The standard municipal letter of credit is a simple document whereby a municipality wishes to realize on the security given to it by a third party. This usually occurs because of a default of certain obligations by the third

party. Typically, the condition in a letter of credit requires the municipality to certify that the draw upon the letter of credit arises because of an agreement between the municipality and the applicant. Not often is there a requirement that the municipality must declare that the third party is in default or that the municipality will undertake to do the work.

Conclusion

If the courts have consistently recognized the autonomy or independence of a letter of credit and if the courts have set a high standard of proof on those alleging fraud and who seek to prevent an issuer from paying on a letter of credit, then municipalities may come to the conclusion that there is sufficient commercial certainty so that municipalities can rely upon letters of credit as acceptable security without invoking ISP98. While ISP98 is a document worthy of the intricacies of international trade, perhaps municipalities should heed the preface to ISP98 where it declares that ISP98 provides neutral rules which are acceptable in the majority of situations and that it is a useful starting point for negotiations.[42] In other words, municipalities could agree to have only certain ISP98 rules apply to municipal letters of credit and thereby use rules that would benefit municipalities while excluding rules that would not generally apply to municipal situations.

ENDNOTES

[1] An informal survey conducted in April 2004 involving major municipalities in Canada ("Informal Survey").
[2] *International Standby Practices- ISP98*, The Institute of International Banking Law & Practice, Inc. (1998) ("ISP98").
[3] Steven P. Jeffery, "Standby Letters of Credit: A Review of the Law in Canada" 14 B.F.L.R. 505 at 507 ("Jeffery").
[4] Robert J. Spjut, "Documentary and Standby Letters of Credit" Eagle Traders.com 1-2 ("Spjut").
[5] *Ibid*. at 2.
[6] Jeffery *supra* note 3 at 513.
[7] *Ibid*. at 507.
[8] Spjut *supra* note 4 at 2.
[9] Jeffery *supra* note 3 at 507.
[10] ISP98 supra note 2 at 5.
[11] Jeffery *supra* note 3 at 511.
[12] *Ibid*. at 511-512.
[13] [1978] 1 All E.R. 976 (C.A.).
[14] *Ibid*. at 981.
[15] [1987] 1 S.C.R. 59 ("*Angelica-Whitewear*")
[16] *Ibid*. at 70.
[17] Jeffery *supra* note 3 at 521.
[18] *Canadian Encyclopedic Digest*: Banking- Guarantees 797.
[19] *Distribulite Ltd. v. Toronto Board of Education Staff Credit Union Ltd.*, (1987) 45 D.L.R. (4th) 161.
[20] Jeffery *supra* note 3 at 522.
[21] See *Cineplex Odeon Corp. v 100 Bloor West General Partner Inc*., 1993 WL 1450994 (Ont. Gen. Div. (C.L.)), *Royal Bank of Canada v. Gentra Canada Investments Inc*., 2000 CarswellOnt 248, affirmed 147 O.A.C. 96 (Ont. C.A.), *Standard Trust Co. v. Bank of Nova Scotia*, 2001 CarswellNfld. 150 (Nfld. C.A.), and *Century Property & Casualty Insurance Corp. v. London Guarantee Insurance Co*., 1999 CarswellOnt 3897 (Ont. S.C.J.)
[22] *Angelica-Whitewear supra* note 15 at 84.
[23] *Ibid*. at 96.
[24] John F. Dolan, "The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?" 13 B.F.L.R. 1.
[25] *Uniform Customs and Practice for Documentary Credits- UCP 500*. , International Chamber of Commerce Publication No. 500, effective January 1, 1994.
[26] Informal Survey *supra* note 1.
[27] Paul S. Turner, "New Rules for Standby Letters of Credit: The International Standby Practices" 14 B.F.L.R. 457 at 459.
[28] ISP98 *supra* note 2 at 9.
[29] *Ibid*. at 5.
[30] *Ibid*. Rule 1.01(a).
[31] *Ibid*. Rule 1.01(d).
[32] *Ibid*. Rule 1.06(b).
[33] *Ibid*. Rule 1.06(c).
[34] *Ibid*. Rule 4.03.
[35] *Ibid*. Rule 4.07.
[36] *Ibid*. Rule 4.12.
[37] *Ibid*. Rules 4.16-4.21.
[38] *Ibid*. Rule 1.06(a).
[39] *Ibid*. Rule 1.07.
[40] *Ibid*. Rule 5.01.
[41] 1999 CarswellOnt 184.
[42] ISP98 *supra* note 9 at 8.