



Business Transactions Legal Update

Letters of Credit - How a Seller Can Ensure Payment Even in a Bad Economy

As the United States and global economies sour and companies severely delay or default in their payment for goods (including filing for bankruptcy), now is a great time to consider using a letter of credit. Letters of credit, which are typically issued by financial institutions, ensure payment to the seller for goods sold even if the buyer fails to pay. If a seller is concerned about a buyer's creditworthiness, then it can insist upon a letter of credit in an amount equal to the sales price of the goods prior to agreeing to the sale. In the event that the buyer fails to make timely payment, the seller is entitled to seek payment from the issuer under the letter of credit. Even in the event that the buyer files for bankruptcy, the seller should still have the ability to collect payment under the letter of credit from the issuer absent extraordinary circumstances.

Letters of credit have certain terms and conditions that must be satisfied before the issuing institution is required to make payment to the seller. In the United States, Article 5 of the Uniform Commercial Code (the "UCC") governs letters of credit, although it is not unusual for the parties to choose to have letters of credit governed by the Uniform Customs and Practice for Documentary Credits (which is essentially the same for purposes of this article). Under Section 5-108 of the UCC, issuers must honor demands for payment that strictly comply with the terms and conditions of the letter of credit. While the statute does use the term "strict compliance," various judicial decisions have held that strict compliance does not mean "oppressive perfectionism" or "slavish conformity." Nonetheless, there is no reason for the seller to take any unreasonable risk in presenting a letter of credit for payment or to incur legal fees by commencing litigation because the seller did not strictly comply with the terms of the letter of credit even though it could have easily done so.

One New York case (J.P. Doumak, Inc. v. Westgate Financial Corp., 776 N.Y.S.2d 1 (N.Y. App. Div 2004), appeal dismissed, 3 N.Y.3d 635 (2004)), illustrates the danger of failing to strictly comply with the terms of a letter of credit. In the end, the failure by the seller of goods to make a timely written demand for payment as required under the letter of credit prevented it from recovery. The lessons learned herein should provide you with valuable guidance.

J.P. Doumak, Inc. ("Doumak") and John Michaels, Inc. ("Michaels") entered into an agreement whereby Doumak was to sell fabric to Michaels. As part of this transaction, Michaels obtained a guaranty from defendant Westgate Financial Corp. ("Westgate") in favor of Doumak. (Because the court subsequently found that the "guaranty" was really a letter of credit, this article hereinafter refers to the guaranty as a letter of credit.) The letter of credit required Doumak to present Westgate with certain documents and also required that Doumak make a written demand for payment under the letter of credit prior to August 21, 2000.

After shipping the fabric to Michaels, Doumak sent Westgate a letter on or around June 30, 2000, enclosing the required documentation together with a letter stating as follows: "If you should require any additional documentation or information, please do not hesitate to contact us." Nothing in the letter actually demanded payment under the letter of credit. On September 7, 2000 (several weeks past the August 21, 2000 deadline), Doumak sent another letter to Westgate demanding payment under the letter of credit. After Westgate refused to pay, Doumak sued to recover under the letter of credit.

Doumak moved for summary judgment and the lower court granted the motion, however, the Supreme Court, Appellate Division, reversed the lower court's decision and granted defendant Westgate's motion to dismiss the claim. The Appellate Division found that Doumak's letter was insufficient to satisfy the "written demand" requirement under the letter of credit and Section 5-108(a) of the U.C.C. as adopted by New Jersey (the court noted that it found no difference between the equivalent New York statute), that requires that an issuer honor a presentation

which appears on its face strictly to comply with the terms and conditions of the letter of credit. The New York Court of Appeals (the highest court in New York) dismissed the appeal.

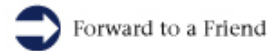
In another case from a different jurisdiction, a typographical error in the payment request documentation was the subject of a lawsuit over whether the beneficiary could collect under a \$250,000 letter of credit. While the letter of credit specified that the "Letter of Credit No. 86-122-S" be referenced, the actual payment request specified "Letter of Credit No. 86-122-5." While the court ultimately ruled in favor of the beneficiary, this lawsuit shows the importance of strict compliance to minimize undue risk when dealing with letters of credit.

How To Protect Yourself

How can you ensure that something similar does not happen to you? First, as we learned in the Doumak case, always strictly comply with the terms of the letter of credit. If a written demand for payment is required, then this should be done. In addition, if a letter of credit requires you to specifically reference the letter of credit number, make sure you do that accurately. If a letter of credit requires that an officer of the company sign the demand letter, make sure that an officer does sign the demand letter and identifies his or her official capacity. In sum, strictly follow the letter of credit requirements.

Second, always carefully review a draft letter of credit beforehand to understand all of its requirements. Many are quite specific as to what a beneficiary must do to comply with its terms. For example, the letter of credit might require the beneficiary to present supporting documentation in person at a specific branch location in a specific city. If this particular location is inconvenient for you, you should reject it. Instead, insist on either (1) being able to deliver the required documentation by mail or overnight courier to the specific location or (2) changing the location to one that is more convenient for you; otherwise, you may set yourself up for failure.

Third, you should always present the original letter of credit even if it is not specifically required in the explicit terms. Consequently, it should be kept in a safe but reasonably accessible location so that you can quickly retrieve and present it if necessary.



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