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Risky and Uncertain Situations in Negotiation of LCs

The LC concept of negotiation has led to considerable misunderstanding and confusion in practice. In his article, Abdurrahman Özalp attempts to wade through areas of uncertainty and cast light on difficulties that confirming banks and beneficiaries could encounter.



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In the context of letters of credit, "negotiation" typically refers to the advancing of funds by a nominated bank before a credit's due date by purchasing documents through another party. Under the current UCP rules, negotiation is defined as "the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or

documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank.”¹ As evidenced by court decisions worldwide, there have been differing interpretations of the definition of negotiation across jurisdictions.²

In letter of credit transactions, negotiation is applied as defined in the UCP. However, there can be uncertainties in some instances, particularly significant for the confirming bank and the beneficiary of the credit. These uncertainties include ambiguity as to the timing or non-arrival of payment at the designated place. The situation can arise when the ultimate debtor bank, usually the issuing bank, experiences disruptions due to financial insolvency, bankruptcy, force majeure, or regulatory compliance reasons. Under such circumstances, this uncertainty needs to be properly managed. Although the risk is generally apparent, in the context of LC transactions, and especially confirmed LCs, these factors can often be overlooked.

A credit available by negotiation necessarily involves a nominated bank and uses the method "by negotiation" is a type of letter of credit. According to the UCP, the issuing bank has no ability to negotiate because it is the ultimate debtor. For negotiation to occur, someone else's debt must be purchased. Negotiating under an LC involving required documents presented differs from the negotiation of mere negotiable instruments such as promissory notes, clean bills of exchange, and bonds. For bonds, there is a bill of exchange that can be pursued, whereas in LC transactions, except for acceptance credits, no negotiable instruments are involved.

Other than acceptance credits, negotiation conducted under credits using the "by negotiation" method are not based on valuable paper (negotiable instruments or documents). Rather, it is based on the commitment of the debtor bank, which could be the issuing bank or, rarely, the nominated bank, if accepted to act on its nomination without recourse to the beneficiary or act as confirming bank. If the party who is purchasing the commitment faces a disruption or the debtor has disappeared, there will not be a bill of exchange to pursue, i.e. to make it subject of a legal proceeding.

In explaining the uncertainty mentioned above, when referring to the due date of the purchased amount being indefinite or never occurring, we are referring to a situation where the nominated bank, while making the purchase, has not yet received acceptance (on the face of a paper) from the debtor for the purchased amount. However, in the case of

purchasing negotiable instruments such as accepted drafts or signed promissory notes, there is an accepted definite debt and the due date is certain, not indefinite.

see also: *Should "Negotiation" Continue to be a Form of Availability within UCP?*

The due date for reimbursement in an LC available by negotiation will be determined after the documents reach the obligor bank, i.e, the issuing bank or another nominated bank (who acted on its nomination only or confirmed). The presence of a draft at sight in an LC for negotiation, which we sometimes encounter, should not be misleading as even if a draft is issued, there is no negotiable instrument that has been accepted and can be further purchased. The drafts in negotiation credits are not accepted drafts but merely issued drafts, meaning they do not yet have the status of negotiable documents.

An ICC Guidance Paper,³ on drafts discourages use of sight drafts because they do not involve an acceptance condition.

The operations of purchase in negotiation credits rely not on the law of negotiable instruments but on a private arrangement between the beneficiary and the purchaser. If necessary, matters such as recourse, uncertainty regarding the timing of payment, risks, and precautions should be defined in this private agreement.

While this can be somewhat managed in unconfirmed credits by a negotiation agreement between negotiating bank and beneficiary, it poses a problem for both the beneficiary and the confirming bank in confirmed credits as the commitment of the confirming bank relates to the irrevocable completion of the purchase, i.e. negotiation. In practice, banks seldom make a special agreement to reflect the risk of uncertainty regarding the payment timing to the beneficiary when confirming an LC.

If the confirming bank wishes to enter into such an arrangement, it will likely be rejected by the beneficiary, as it will need to state that the debtor bank's payment is contingent upon the timing of the obligation which the beneficiary will not accept. This is because, in such a case, the beneficiary would be taking on the risk of the debtor bank and its country, rendering the confirmation meaningless.

However, in reality, this is exactly the situation, albeit implicitly. A beneficiary wants an LC confirmed because it does not want to bear country risk and issuing bank risk. In such a

case, where a negotiation agreement is involved, the beneficiary will be aware of this situation and will not accept it.

Where might a confirming bank face difficulties?

Particularly in cases of the drawee bank's bankruptcy and/or force majeure, there will be uncertainty concerning the timing of payments. If the beneficiary requests confirmation, the bank may not be able to determine pricing and mitigate risks.

In confirmed LCs that do not contain specific conditions regarding pricing and duration of the purchase (which is generally the case), the negotiation is a without recourse payment less interest and charges (cost) upon the request of the beneficiary. Cost is calculated based on the period in which payment is expected to be made by the drawee bank, including interest and commission.

When a purchasing bank (negotiating bank) engages in a purchase (negotiation), it uses its own resources by advancing its own funds, which is, in a sense, an advance and a loan on its books. If the debtor bank/drawee experiences a disruption in its operations due to bankruptcy, force majeure, or any other reason, the negotiating bank will be unable to calculate costs and the advance or loan may remain unpaid.

Where might a beneficiary face difficulties?

There is also risk on the beneficiary's side. If there is no agreed price in writing beforehand or specified in the LC, there will be no limit to the cost that the confirming bank may calculate as a deduction, or it might not be able to calculate costs at all due to the reasons mentioned above, potentially leading to a high expense.

A nominated bank that does not want to negotiate may deliberately offer a high price during the negotiation request. If the beneficiary does not accept an unsuitable price, the negotiation transaction will not proceed, rendering the confirmation meaningless.

Ultimately, both confirming bank and beneficiary must be aware of the circumstances in confirmed LCs and must accordingly assess risks and costs. Normally, confirmation is requested by a beneficiary to eliminate or reduce country risk and issuing bank risk.

However, for the reasons explained, negotiating confirmed LCs may not make sense or may not function in certain situations. As a result, when obtaining or providing confirmed LCs, it may be more appropriate to anticipate these issues and, if necessary, opt for another method of use such as "by payment" or "by acceptance".

In fact, "negotiation" is an important financing mechanism. The aim here is not to prevent use of "negotiation" and/or completely remove it from letters of credit, but to use it by recognizing the inherent risks and uncertainties and taking the necessary precautions.

1. UCP600 Article 2 (Definitions). ↩

1. *The Bank of East Asia (China), Da Lian Branch v. Da Lian Hui Feng Da International Trade Co. Ltd.*, [(2014) Civil Shen Zi No.680] [P.R.China], abstracted at 2017 Annual Review 460; *China New Era International Ltd. v. Bank of China (H.K.) Ltd.* [2010] 5 HKC 82 (2010) [Hong Kong], abstracted at 2011 Annual Review 411; *Grains and Industrial Products Trading Pte Ltd v. Bank of India*, [2016] SGCA 32 [Singapore], abstracted at 2017 Annual Review 500; *Korea Exchange Bank v. Bank of China*, No.2009-93817, Supreme Court 2nd Division, (Jan. 27, 2012) [Korea], abstracted at 2013 Annual Review 429 . ↩

1. ICC Guidance Paper - The Use Of Drafts (Bills Of Exchange) Under Documentary Credits, 8 Jan 2019. ↩

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