

## RISK AND UNCERTAINTY SITUATIONS IN NEGOTIATION DOCUMENTARY CREDITS

In the context of documentary credits, "negotiation" refers to the payment of a sum before its due date by purchasing it through another party. A letter of credit is generally a conditional, irrevocable bank commitment, subject to the Uniform Customs and Practice for Documentary Credits (UCP) established by the International Chamber of Commerce (ICC). Under the UCP, negotiation is defined as the purchasing of bills (drawn on a bank other than the issuing bank) and/or documents under a comply presentation, where the nominated bank makes an advance payment to the beneficiary, or agrees to make such a payment, on or before the banking day on which reimbursement is due from the issuing bank. The definition of negotiation may vary across different national laws, as evidenced by court decisions from various jurisdictions worldwide that provide differing interpretations<sup>1</sup>. In letter of credit transactions, negotiation is applied as defined in the UCP. However, there can be uncertainties in some cases, particularly significant for the confirming bank and the beneficiary of the credit. These uncertainties can be summarized as the ambiguity about the timing or the non-arrival of the payment at the designated place. This situation can arise when the ultimate debtor bank, usually the issuing bank, experiences disruptions due to financial insolvency, bankruptcy, force majeure, or legal reasons. This is a scenario of uncertainty that needs to be properly managed. Although the risk is generally apparent, in the context of letter of credit transactions, and especially in confirmed documentary credits transactions, this uncertainty can often be overlooked. A negotiation credit, which necessarily involves a nominated bank and uses the method "by negotiation", is a type of letter of credit. According to the Uniform Customs and Practice for Documentary Credits (UCP), the issuing bank has no obligation to negotiate because it is the ultimate debtor. For negotiation to occur, someone else's debt must be purchased. Negotiating under a letter of credit, involving the required documents presented, differs from the negotiation of mere negotiable instruments, such as Promissory notes, clean Bills of Exchange, bonds etc. In the latter, there is a bill of exchange that can be pursued, whereas in letter of credit transactions, except for acceptance credits, there are no negotiable instruments involved. Other than acceptance credits, negotiations conducted under credits using the "by negotiation" method are not based on a valuable paper (negotiable instrument/document). It is based on the commitment of the debtor bank, which could be the issuing bank or, rarely, the nominated bank. If the party who is purchasing the commitment faces a disruption or unreachable situation of the debtor, there will not be a bill of exchange to pursue.

In the context of defining uncertainty in above, when referring to the payment time of the purchased amount being indefinite or never occurring, we are referring to a

---

<sup>1</sup> Leading Court Cases on Letters of Credit, King Tak FUNG, ICC Publication, page 36-37

situation where the nominated bank, while making the purchase, has not yet received acceptance from the debtor for the purchased amount. However, in the case of purchasing negotiable instruments such as accepted drafts, signed promissory notes, there is an accepted definite debt, and the payment time (due date) is certain, not indefinite.

The due date for payment in a letter of credit for negotiation will be determined after the documents reach the obligor bank, i.e, issuing bank or another nominated bank. The presence of a draft (draft at sight) in documentary credits 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 valuable/negotiable documents.

According to ICC Guidance Notes<sup>2</sup>, the use of sight drafts is not recommended 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 contract 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 contract.

While this can be somewhat managed in unconfirmed credits, 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, almost no bank adding a confirmation for a negotiation credit doesn't make a special contract reflecting the risk of uncertainty in payment timing to the beneficiary.

If a confirming bank wishes to enter into such a contract, it is unlikely to be accepted by the beneficiary, as it would have to state that the payment obligation depends on the drawee bank's payment timing. The beneficiary would not accept this, as it would then bear the risk of the drawee bank and its country, rendering the confirmation meaningless.

In reality, even if it is implicit, this is exactly the situation. A beneficiary of a letter of credit, not wanting to bear the country and Issuing bank risk, requires a bank confirmation. 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?

---

<sup>2</sup> ICC Guidance Paper - The Use Of Drafts (Bills Of Exchange) Under Documentary Credits –8 Jan 2019

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 letter of credit transactions that generally lack specific terms for price and duration of negotiation [which are usually absent], negotiation is a without recourse deducted early payment less interest and charges payment made upon the beneficiary's request.

The deduction involves a cost calculated based on the estimated time frame, including interest and commission, which the drawee bank is supposed to pay.

When the negotiation bank performs negotiation uses its own resources, this effectively becomes an advance and credit. If the drawee bank faces bankruptcy, force majeure, or any other disruption, the negotiation bank will not be able to calculate the cost.

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 letter of credit, 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 it at all due to the reasons mentioned above, potentially leading to a high cost.

There is nothing to prevent a bank that does not want to perform confirmation from setting a high price. If the beneficiary does not accept an unsuitable price, the negotiation transaction will not proceed, rendering the confirmation meaningless.

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

However, as explained above, a confirmation, which is an irrevocable commitment, may be meaningless or unworkable in some situations. Therefore, when obtaining or issuing confirmation to negotiation documentary credits, it is advisable to take into considerations these issues and, if necessary, to prefer other methods of utilization such as "by payment" or "by acceptance", which have a certain payment time, in documentary credits. 1 May 2024

Abdurrahman Özalp

[www.abdurrahmanozalp.com](http://www.abdurrahmanozalp.com)