HERRICK

New York Office
2 Park Avenue
New York, New York 10016
Phone: (212) 592-1400
Fax: (212) 592-1500

Princeton Office
210 Carnegie Center
Princeton, New Jersey 08540
Phone: (609) 452-3800
Fax: (609) 520-9095

Newark Office
One Gateway Center
Newark, New Jersey 07102
Phone: (973) 274-2000
Fax: (973) 274-2500

LENDING AND RESTRUCTURING ALERT
FEBRUARY 2003

Strict Reading of Letter of Credit Costs Bank Over $70 Million

A recent decision by New York's highest court illustrates the importance of ensuring that all pertinent terms and conditions of a letter of credit are explicitly and unambiguously set forth in the document.

In this particular case, a lender loaned $150 million to a borrower. As security for the loan, the borrower arranged for the issuance of an irrevocable standby Letter of Credit (LC) stating on its face that it was payable in favor of the lender for "up to USD 11,500,000" to cover any past due installment under the loan. The LC further provided that it "shall be revolved and reinstated every three months within the period of validity."

When the borrower missed a scheduled installment on the loan, the lender drew against the LC. The issuer disbursed to the lender $11.5 million, the maximum draw available quarterly under the LC. Thereafter, the unpaid principal balance of the loan was approximately $74 million. At the beginning of the next quarter, because the borrower's default was still outstanding, the lender demanded another draw of $11.5 million against the LC. The issuer refused to pay, arguing that reimbursement by the applicant was a condition to the quarterly renewal of credit and reuse of the LC. The lender then sued the issuer, claiming that since the LC renewed automatically each quarter, the bank was liable to pay $11.5 million per quarter.

The Law and its Application

In reaching its decision, the Court cited the fundamental principle that letters of credit must be strictly construed and performed in compliance with their stated terms. The court noted that a letter of credit can revolve in different ways--in relation to time, value, repayment, presentation of documents, or by a combination of factors, depending upon the language used in the instrument.

In this case, the language of the instrument unequivocally established that the $11.5 million credit line renewed automatically upon the passage of time. The document placed no condition on this cycle of revolution and reinstatement, nor did it require the beneficiary to show proof of repayment by the applicant to the issuer. Accordingly, the issuing bank was liable under the LC to pay the beneficiary $11.5 million each quarter that the LC remained outstanding, with the cap being the full amount of principal and interest that the applicant owed to the beneficiary.

Conclusion

Strict construction of letters of credit assures their reliability as a payment mechanism. It is understandable that the issuer of a letter of credit may want to condition renewal of the credit line on repayment by the applicant or cap the extent of its liability under the instrument. But to make its obligation to pay under a letter of credit conditional, the issuer must clearly and explicitly set forth the conditions in the instrument. As the case discussed above demonstrates, the issuer's failure to do so can be very costly.

For more information on these issues, please call Paul Rubin **212-592-1448** or prubin@herrick.com, Andrew Gold **212-592-1459** or agold@herrick.com.