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Jacob I. Corré
Chicago-Kent College of Law

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RECONCILING THE OLD THEORY AND THE NEW EVIDENCE

Comments on Ronald Mann's 'The Role of Letters of Credit in Payment Transactions'

*Jacob I. Corré**

Ronald Mann's thorough research and rigorous analysis provide compelling evidence that the commercial letter of credit does not further the fundamental purpose traditionally associated with it.[1] Equally persuasive are his hypotheses about the functions that letters of credit actually serve in the real world. The objective statistics are startling. An overwhelming majority of letter of credit seller-beneficiaries make at least initial presentations to issuing or correspondent banks that by the express terms of the letter of credit do not entitle the seller to payment.[2] Without a waiver from its customer, the issuing bank is legally entitled to, and surely will demand, strict compliance with these terms.[3] It is only the voluntary foregoing by the buyer-applicant of its own unambiguous formal power, which is essentially always forthcoming, that enables the seller to draw on the letter of credit. Thus, the normal course of a letter-of-credit transaction at least initially places the seller at the mercy of the buyer.

Given these empirical findings, it is difficult to believe that the persistent use of letters of credit in commercial transactions has anything to do with their theoretical potential to ensure that the seller actually gets paid. It is difficult to believe, but not impossible. Mann recognizes that his evidence does not conclusively refute the traditional view that the principal function of the letter of credit is to assure payment. At least one plausible conceptual account of the letter of credit remains that is consistent both with the new, surprising empirics and the old idea that the commercial letter of credit is primarily an atomic element of the payment system. The traditional view does not depend

* Visiting Assistant Professor, Chicago-Kent College of Law; A.B. 1981, University of Chicago; J.D. 1985, Yale. — Ed.

1. *See generally* Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494 (2000).

2. *See id.* at 2502-05.

3. *See id.* at 2499-501; *see also* U.C.C. § 5-108(a) (1999) (stating issuer's obligation to honor letter of credit depends on strict compliance with terms and conditions of letter of credit).

on the legal enforceability of letters of credit because one does not need legal rights to feel assured of payment.

The account that I propose begins by identifying and contemplating the consequences of a likely disjunction in the locus within the firm (particularly the seller's firm) of the agency costs generated in the issuance of letters of credit, on the one hand, and in the performance of the conditions required before the seller is entitled to draw on the letter of credit on the other. Imagine a straightforward, very large one-time sale of a commodity by a seller who routinely does business around the world, and a buyer located in a country where the seller has little or no experience. The seller is represented by a firm-specific marketing representative who, lacking sufficient information about the buyer's reliability, demands a letter of credit. The seller wants the letter of credit only as a means of assuring payment. The buyer agrees. The terms of the letter of credit could, in theory, be worked out by the agents who struck the deal themselves. Alternatively, the parties, after agreeing on a particular issuing bank, might simply adopt and adapt a form of letter of credit routinely utilized by the bank; indeed, the bank might insist that the letter of credit be based on such a form. They could hand the matter over to lawyers, in or out of house, and the bank's lawyers will probably need to look at the resulting papers before the bank commits itself. The letter of credit that the bank finally issues will contain specific terms, ordinarily requiring that a particular set of documents evidencing shipment of the goods be presented to the bank in a particular manner within a particular time frame. Information as to precisely which documents must be presented to the bank, and when and how they need to get there, will be within the purview of any one agent or group of several agents of the seller, who may or may not be employees of the firm. There is no a priori means of determining where that information is. What the seller needs to do in order to get paid under the letter of credit may be costly to determine.

The seller ships the goods. It is time to figure out how to draw on the letter of credit. Who will handle that task? Perhaps the job will go to an employee in the department that handled the shipping; maybe it will be a more specialized person in the Accounts Receivable department. Whoever has the job of assembling the documentary evidence of the seller's performance will not necessarily know what the particular letter of credit requires, in terms of substance, mode of presentation, or timing. In fact, it seems unlikely that the party who must assemble the documents that the seller will present to the issuing bank had anything to do with the process by which the letter of credit was issued. That person could search for those requirements but the search would be costly, both in terms of locating the source of the relevant information and learning the requirements. When she finds and learns the specific conditions, it may turn out that they require conduct that is not part of the seller's standard method of complying with letter-of-credit conditions. That will further reduce the seller's share of the surplus that the sale created.

It will surely be tempting to achieve at least some degree of standardization in the process of presenting documents to the issuing bank. The costs saved by doing so could well exceed the costs associated with the increased risk of the issuing bank's refusal to allow a draw on the letter of credit for failure to satisfy its conditions. One of Mann's central discoveries is that the risk of the bank not paying because the documents presented fail to conform in some respect to the formal terms of the letter of credit is astonishingly low. But such data may be consistent with the use of letters of credit primarily as a payment instrument. Even without an issuing bank's pressuring its customer to waive the conditions, there is good reason to expect a rational buyer to waive the conditions, at least in cases where the seller seems to have performed the underlying contract adequately. The buyer would remain obligated under that underlying contract. The buyer would rarely refuse to waive the conditions of the letter of credit draw if it intended to pay for the goods. So, refusal to waive would ordinarily imply refusal to pay. Sometimes refusing the waiver would be pointless because the seller can simply resubmit documents that conform. The buyer will often waive even when the seller will not be in a position to resubmit, say, because too much time has passed. The buyer will assign an expected cost of refusing to pay that will be the sum of its expected legal liability and the expected cost of the reputational and other nonlegal sanctions it could suffer. If that cost is greater than the benefit of not paying, a rational buyer might as well waive. A rational and sufficiently informed seller (with a particular range of attitudes toward risk) who does the analysis just outlined might well have good reason to save the costs of conforming to the requirements of particular letters of credit.

Such a decision could be expected to occur even in one-time transactions. A repeat-play relationship between the buyer and seller should significantly enhance the likelihood that the buyer will waive the letter-of-credit conditions. Part of the cost that the buyer would bear by refusing to waive the conditions in an ongoing relationship would lie in the damage to the relationship itself — a cost that obviously grows with the expected value of future dealings. As such, the evidence of how the parties actually behave in the typical letter-of-credit setting, coupled with the traditional view of the letter of credit as principally a payment mechanism, makes the letter of credit another potentially interesting case study in the important body of literature that views the formal rules of a particular contractual relationship as rules to be applied in an end-game situation.[4] Where the expected future value of a relationship approaches zero, one would expect to see increased opportunistic resort to strict contractual terms. Of course, in such circumstances the seller, perceiving that the buyer is more likely to refuse to waive strict application of the letter-of-credit terms, will place a higher value on strict conformity with those terms, and would accordingly be more likely to incur the intrafirm agency costs necessary to implement strict compliance with the particular letter of credit in question. It would be interesting to know whether the rate of compliance that one finds correlates with the length and stability of the underlying commercial relationship. It can only be hoped that Mann's important study will foster the development of more sophisticated models that justify the continued use of the traditional letter of credit, and that he will use the extensive data set that he has generated in preparing his current work — which he modestly calls "preliminary" — to test those models.

The alternative functions of letters of credit that Mann describes are all consistent with the data regarding rates of initial presentation compliance by sellers, and of waiver by buyers. The letter of credit serves as a signal to the seller of the buyer's reliability because a bank would not vouch for an unreliable party. It also signals the legitimacy of the transaction itself since banks are relatively advantaged in determining, or more highly motivated to determine, that the transaction in question is not merely a ruse to circumvent licensing requirements, launder money or the like. The desire for transaction verification may come from a seller motivated to avoid potential secondary liability for facilitating unlawful conduct, or directly from regulations which require that the transactions in question be implicitly verified by a sufficiently reputable organization. Finally, the letter of credit also can minimize agency costs within the seller's firm because the agents who generate the sales will usually not be the ones charged with determining the firm's willingness to undertake particular classes of credit risks. That each of these functions commonly plays an important role in motivating the resort to letters of credit also gains support to varying degrees through the interviews that Mann has conducted with bank personnel active in administering letters of credit to supplement his objective statistics.[5]

Each of these alternative explanations, tied together nicely by Mann's reconceptualization of the letter of credit from a payment mechanism to a "verification institution," clearly plays some role in the continued resort to letters of credit, even though they are among

4. *See, e.g.*, Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996).

5. *See, e.g.*, Mann, *supra* note 1, at 2508-09, notes accompanying text on 2517-19, 2524, 2527-29, and notes accompanying text on 2532-36.

the more expensive means of ensuring payment. The present study does not purport to inquire into or offer any evidence of the relative frequency with which each of these functions plays a significant role in the generation of a letter of credit. However, this reorientation of the theoretical foundations of the letter of credit has identifiable and significant implications for the agenda of future empirical research. The findings already obtained probably contain strong indicia of the relative significance of the different verification functions identified.

The degree to which each of the three verification functions Mann has identified motivates the use of a letter of credit ought to correlate significantly with the transactors' decision to continue utilizing the letter of credit over the course of a sustained relationship. Consider the first verification function: the letter of credit is an instrument by which a bank, as the party that can at the lowest cost obtain information regarding the buyer's creditworthiness, signals the seller that the risk of the buyer's default is acceptably low. Such information will be important early in a relationship because the seller has no personal information about the buyer. Over the course of a relationship solidified by iterated success in individuated transactions, the seller does gain its own specific information about the buyer. The buyer's willingness to waive deviations between the seller's documentary presentations and the express terms of the particular letter of credit may actually hasten the process by which the seller comes to trust the buyer. With or without such opportunities for a buyer to signal its willingness to cooperate, the marginal utility of the bank's signal about the buyer should begin to decrease more or less quickly. At some point the marginal increase in the seller's expected gain from the transaction attributable to the bank's signal about the buyer's reliability will be insufficient to justify the cost of the continued deployment of the letter of credit. At that point one would expect to see the parties shift from reliance on a letter of credit to a cheaper method of bonding the buyer's performance, such as a documentary collection transaction.

The "transaction verification" function presents a more complicated picture. Insofar as the need for verifying the authenticity of a sale comes from the seller concerned with either nonpayment or secondary liability, it can be expected to follow more or less the same course as the "vouching for the buyer" function. After enough good sales, the seller will be confident enough in the buyer's reliability that the increase in comfort that a letter of credit delivers won't be worth the price. But if the letter of credit instead serves to assure a regulatory authority that the sale is real, it is unlikely that the demand for such assurance will be particularly sensitive to the length or stability of a particular relationship. The optimal precision in the applicable regulation is likely to be based on the nature of the transaction rather than the history of dealings between particular parties, a factor that would significantly increase the regulator's cost of determining whether a particular transaction falls within the scope of the regulation. Accordingly, the use of the letter of credit would persist over the entire course of even the most successful relationship.

The need for intrafirm verification will perhaps also decline over the course of a repeat-play relationship. Trust can mollify the need for costly constraints on transactional form aimed at constraining risk taking to the appropriate level in an organizational hierarchy in much the same way as general reputation can. Imagine a rule within a seller's firm that transactions over a certain amount require a letter of credit. Such a rule could be expected to give more discretion to low-level agents dealing with longstanding customers. It would be just as rational to design such a rule as it would to require a lower level of approval to sell to Microsoft or General Motors on open credit than to offer the same terms to an e-business start-up company. A firm governed by this rule would resort to letters of credit less in repeat-play relationships. Mann's subjective empirical work with bank officers confirms this phenomenon.

Mann's groundbreaking article demarcates several new paths for both theoretical and empirical research. These paths point to a deeper understanding of areas beyond the basic commercial letter of credit. The letter of credit is a form of agreement that may be regulated by local law, the Uniform Commercial Code, or by international convention, the Uniform Customs and Practice. Mann's article suggests that there may be significant variations between letter-of-credit practices in domestic and international transactions. How extensive are these differences and can they be conceptually correlated with differences in the underlying legal regimes? The letter of credit thus seems to offer an excellent opportunity for studying the effect of background allocations of right — "the shadow of the law" — on actual commercial practices. Mann's article also has implications for the investigation of transactional forms related to the straight letter of credit in a basic sales transaction. Given that one basic function of the letter of credit is to sever the source of the obligation to pay from the actual practice of payment, whether or not it operates primarily as a payment mechanism, studying the choice of a letter of credit over a secondary obligation such as the standby letter of credit promises a good chance to verify and expand on important recent work in the legal and economic foundations of the guarantee contract.[6] Mann's data and his analysis both make possible and demand a number of promising lines of future research.

6. *See* Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47 (1999).