INTERNATIONAL FINANCIAL SERVICES ASSOCIATION 2000 ANNUAL MEETING

The following is an adapted text of the Annual Meeting presentation made on 25 September at IFSA 2000 by Philip Chappo, Chair, Roy DeCicco, Vice Chair/Chair Elect, Bethany McClellan, IFSA Board Member and Dan Taylor, President.

Until recently, we were probably correct to think of the IFSA as a closed system. We were a relatively small group of financial services professionals with a narrowly defined sphere of interests and influence that extended only as far as our own borders and practice.

We can be proud of how much that has changed. The International Financial Services Association in the year 2000 is an open and far-reaching network. We represent the pathways and connections between the organization itself, the world-class institutions and financial services industry leaders who are our members, the thought pioneers in technology, security, communications, and personnel who are our suppliers, and the regulators and legislators who so strongly impact the climate for the international commerce we support.

The IFSA has always meant great opportunities for networking. But today, we have truly become a network. Where the IFSA ends and where the industry begins is a fuzzy line, getting fuzzier. We are connecting more often, more powerfully and in more different ways than ever before – with each other, with our suppliers, and with our partners around the globe.

In his recent book of the same name, Kevin Kelly of Wired magazine outlines his New Rules for the New Economy. It's good reading, filled with mind-bending thoughts and observations that nonetheless ring true for those of us in the financial services industry. We were struck by the parallels with our organization.

This IFSA, the IFSA of 2000, that is, is a very different organization than that of 1989 or even 1999. While continuing to be a source of information, advocacy, education, and community, we have transformed ourselves into a much more open, collaborative, and far-reaching organization. An organization that has already adopted many of the "radical strategies" proposed in Kevin Kelly's book. This evolution is the subject of our 2000 Annual Meeting.

Our assertions may come as a surprise. After all, we in the financial services operations industry have seldom been accused of trend setting. We're not known for piercing ourselves with anything more adventurous than an occasional paper cut. And, for many of us, "dress-down day" means we wear a navy blue blazer instead of our usual navy blue suit.

But paging through Kelly's book we were pleased to note that, radical strategies or not, the IFSA has made significant strides in serving its members needs in a changing world. One of Kelly's main themes is that the new economy acts like a net, or network, instead of a closed system like an atom. We are so interconnected – by fiber optics and wireless transmission, hubs, nodes and switches, e-mail, voice-mail, and html – that the lines of any organization or group are blurred almost beyond recognition. Employees act like customers. Customers act like employees. Suppliers act like internal departments. Competitors act like partners. Even governments act like businesses – sometimes.

All of this is confusing and borderline chaotic. But it's the way of the world. And this "network logic" of the new economy has substantial benefits to those who are willing to go with the flow. One example is "the law of increasing returns." It's based on the idea that the value of a network increases exponentially with each new member added.

Suppose you had a coffee shop with 10 customers who each bought a cup of coffee every day. If you added one more customer, you could expect to add 10 percent to your revenue. But suppose you had a phone network with 10 customers who called each other once a day. (That's equal to 10^2, or 100 calls.) If you added one more customer, you could expect to add 21 percent to your revenue. Why? Because 11^2 is 121 calls per day. That's an academic way of quantifying what we all know the bigger and more accessible a network gets, the more valuable it is to the members who rely on it for information and interconnection. The more valuable it is, the faster it attracts new participants, which in turn makes it even more valuable to its members.

Applying Kelly's logic to the IFSA does not necessarily mean that our membership will expand in absolute terms but that "growth" will manifest itself in other ways, especially since our industry is consolidating. Although the year 2000 has seen our membership continue to expand outside the United States, this is less about the members of our organization and more about the members of our network – the IFSA network. In addition to the members of the IFSA, and we include in that both the financial institutions who are our members and you, the individuals who represent those institutions, the IFSA network includes our associate members, regulators and legislators across the globe and even partner organizations like S.W.I.F.T. and the ICC. This network is not shrinking it is expanding. For proof, we need to look no further than the IFSA website.

We rolled out the redesigned website one year ago at IFSA 1999. Our philosophy and intention was simple to make the website a prime avenue for the delivery of member services. This avenue would be faster, more complete, more convenient, and (not to be forgotten) more economical, allowing us to spread dues dollars farther. And the IFSA website has lived up to that promise. This past year, for example, sixty percent of our new members joined and paid for their membership online. We have migrated the IFSA newsletter to the web. We've been able to expand the content from six printed pages to the equivalent of sixteen "online" pages, delivered "instantly" while eliminating printing and postage costs. We have replaced our printed directory, a cumbersome and expensive publication, outdated before the ink was dry, with a searchable online directory. We have made the minutes of all committee meetings available online for all members, with a growing archive of past proceedings. And the proof is in the pudding. Whereas roughly five hundred people received the printed IFSA newsletter, more than five thousand have passwords to the members-only section of the website.

Hits on the IFSA website have gone up almost five hundred percent. In August we surpassed 56,000 hits on the site. The statistics show that we are seeing more and more access of the website from outside the U.S. We can break out our hits to see what's coming in from countries like Singapore, South Africa, and India. In fact, they come from over 20 countries each month. And believe us, that growing number of hits from 200 to 400 AM Eastern time is not coming from stateside insomniacs. In fact 26 percent of the hits on the site are outside the typical 9:00 AM to 5:00 PM business hours.

Here's a few more statistics

from the web site you might find interesting. The most active hours of the day are between 10:00 AM and noon; the busiest day of the week is Wednesday; the busiest day of the month is almost always the 18th averaging over 3,500 hits on that day; and, the average visitor spends 5.5 minutes on the site.

Our net is widening, extending far beyond what the members of the three US-bound Councils on International Banking might have envisioned in the seventies and eighties. And with every new participant, every new password, every new hit, the value of the IFSA network grows for each and every one of us.

"It's not about computers," says the New Rules for the New Economy. "Computers are over." They are only tools. The new economy is about communication, or more precisely, the new economy is communication. Nevertheless, the influence of technology that enables communication is profound. "As the world of chips and glass fibers and wireless waves goes, so goes the rest of the world."

As financial services professionals, we know this. We live it every day in our own financial institutions, which have been revolutionized by the advent of practical high-speed digital networks, and are being transformed even further as broadband becomes a worldwide standard. But it's even more incredible to think about the overarching effect of networking technology. Remember that the world wide web was just beginning to work its way into our consciousness five years ago. Five years from now many people predict that over two billion humans will be online. The speed and massive scope of this wave has placed us in a position of continually evaluating our organization. Are we delivering all the member services that we can? Are we doing it in the best way? How do we know?

> ***"We felt that Information is such an important core function of the IFSA that it deserved to stand on its own."***

So, this year the IFSA mounted an inclusive effort to reexamine our strategic plan through the network lens. We brought together our Board members and Committee chairs. And the first thing we did was to reexamine, and reevaluate, our Strategic Plan. We hope you have seen the revised Strategic Plan. But we'd still like to point out some of the important changes we made.

First, you'll see that we added a fourth core function. Along with Advocacy, Education, and Community, we added Information. We felt that Information is such an important core function of the IFSA that it deserved to stand on its own, not assumed to be part of our educational functions. You'll see under Education that we have dedicated ourselves to evaluating and providing viable, new alternate means of delivering programs, using new technologies wherever feasible (such as virtual universities). Under Community we talk about broadening the IFSA's net by exploring opportunities for alliances, partnerships and new chapters that would include global financial institutions, suppliers and other parties to Industry transactions. Then, under Information, we challenge ourselves that "the IFSA will use technology to the greatest extent possible to deliver information and services to the membership and to gather input and information from them." We want to use technology to expand our reach. We believe that the IFSA Technology Leadership Forum is coming pretty close to that. Those of you who could not

make it to New York for our spring 2000 technology forum could access it online through the website and, thanks to our partner SeraNova, see streaming video and hear the proceedings. We also plan to "Increase revenue through web based advertising and services to the industry, supplier network and to the membership..." and "optimize e-business opportunities for the IFSA utilizing the Internet."

In our view, the work of our Board and Committee Chairs to revise our Strategic Plan runs far deeper than word-smithing. Far beyond lip service to technological trends, far beyond adding an "e dash" to our name. In these few new additions to our Strategic Plan are the seeds of a revolution. We as an organization are declaring that the web will no longer be a marketing function – it will be a core business function. Our website will no longer support what we do – it will be what we do. We are opening ourselves to the possibility that the IFSA of 2010 or even 2005 will be so different as to be almost unrecognizable to us today, and yet doing an even better job of fulfilling our mission. And we suggest that the IFSA of the near future may look a lot less like an organization and a lot more like a conversation. We'll look a lot less like a self-contained sphere with our members, suppliers, and partners rotating in neatly defined orbits around us, and a lot more like Kelly's net, with connections reaching here and there in a matrix enabled by technology but enlivened by free-flowing dialogue. We want those 5000 password-holding financial services professionals to be talking. Member to member, competitor to competitor, U.S.-based to Europe, Asia, Pacific Rim, and Africa-based.

One step in that direction is the reorganization of our committee structure. We have taken our 14 technical committees, a vital source of conversation already, and placed them into four product groups. We've named Steering Committees for each of those product groups to facilitate the dialogue between like product areas even more.

Are we finished with the changes? You tell us. Is the transition of our economy finished? Is the financial services world settling back down into predictability? Of course not. In many ways we are obeying the strategy that the _New Rules for the New Economy_ borrowed from the book, _Built to Last_ "preserve the core and let the rest flux." We are staying true to our core values of member service, education, and the success of our industry, while working vigorously to change everything else. "The network is a structure to generate relationships." When you think about it, that's all that the trillions of silicon chips and leagues of fiber optic cable ever produce. No computer ever built a car. No cell site ever transported people from city to city. No DSL line ever cooked a pizza.

But the value of the networks enabled by technology goes far beyond any product or service. Look no farther than our own industry, where we transport trillions of dollars and make every cent of our profit by networking with customers and other financial institutions across the globe.

Kevin Kelly points out that the power of the network is erasing the traditional lines between customer and firm, firm and firm, employee and manager.

When you go to an ATM for example, are you a customer working for yourself, or are you a poorly-paid teller working for the bank? Hard to tell. Yet the speed and convenience of this new kind of relationship is one that few of us would trade away. Similarly, when you take advantage of Amazon.com's features that analyze your purchases, and suggest new books and CD's, are you getting free information to improve your lifestyle, or are you stoking Amazon's mighty

market research engine? The answer, of course, is both. The network is generating relationships.

The IFSA network has been creating this kind of value for a long time. You can see it in all the action on our exhibit floor, where the top suppliers in our industry come each year to show their wares and continue the conversation. We think that we have always worked to enhance the relationship between our suppliers and members. Sure, they're here to sell products. And we're glad to have them as members or partners in our organization. But the relationship goes much deeper than that, and we think our suppliers would agree.

Our lives as financial services operations professionals would be infinitely harder without the specialized systems, hardware and software, micro graphics, word processing, physical security, couriers, communications, office machines & equipment, micro/mini processing, forms management, and personnel consulting services and products they offer us. At the same time we offer our suppliers unparalleled access to their target market.

Nowhere else but here could suppliers to our field be able to find out so directly what financial services professionals think, what we need, where we're going, and what we like and don't like about their products. This is information by which suppliers live and die, and it's here for them, as a benefit of their relationship with IFSA members.

The suppliers who participate actively in the IFSA realize an important truth of the new economy the world's greatest experts on their products and services don't work at their companies. They are here. We, their customers, know more about what their products and services can and should do than they ever will. And that's no slam on them. It's just testimony to the value of the relationship. We think the IFSA has always worked hard to include suppliers in the workings of the organization. And the conversation is deepening year by year.

Our website already includes links for the suppliers who support IFSA. We're looking seriously at expanding this participation, so that suppliers have the option to provide even more information and interchange as part of the IFSA site – to our benefit and theirs. And we are strongly considering what might have been a radical notion even a few years back, and that is, whether our suppliers, as valuable and integral participants in the IFSA network, should be represented on our Board. In the meantime, continue the conversation. Take this premier opportunity to expand your network at IFSA 2000, and visit the Exhibitor Showcase. Talk to our suppliers, and tell them what you need. They'll be more than happy to listen. And to our suppliers, who are here with us, welcome. Please continue to add your expertise and skills to the dialogue and network of relationships that is the IFSA.

This is where the value of our net compounds itself, for you, for us, and for our partners around the globe – regulators, legislators, rule-making bodies and strategic alliances.

The relationships have always been complex in the world of international financial services. The difference now, perhaps, is that what used to be a tangle of barriers and obstacles may now be resolving itself into a very different animal. The driving force for this is undeniable. Communications technology is enabling a volume, speed, and intensity of international networking that the world has never seen. One person at a laptop can truly be a global corporation. Ones and zeroes can be shipped to Johannesburg or Jakarta as easily and quickly as to Jacksonville.

Governmental agencies and standards groups are seeing

the writing on this particular wall, and so, increasingly, they are becoming enthusiastic participants in the net. They know that the effectiveness of the regulations, laws, and standards they support is directly proportional to the willing adherence of institutions and customers, and it is to their great self-interest to join in the conversation.

And there are other groups that have long been a part of the IFSA network, and we of theirs. A few years ago the IFSA conference coincided with the semi-annual meeting of the ICC, and the interchange was valuable for both groups.

We had a presence at the SIBOS conference of S.W.I.F.T. earlier this month, and received a number of inquiries about membership from conference attendees. And the results of the IFSA's continuing participation in formulating rules and regulations are clear.

Last month we conducted a forum for our membership on the new S.W.I.F.T. MT103 message to gain a consensus on the mapping of new fields to FedWire and CHIPS, and how they will be used by our membership. This information is being supplied to organizations around the globe.

The ICC has continued to be a great partner for our organization. We participated in the ICC development of their Uniform Rules and Guidelines for Electronic Trade and Settlement through their Electronic Commerce Project. We are currently co-chairing two important working groups. First, there is a working group that is creating a supplement to the UCP for electronic credits. The second project we are co-chairing is the ICC's creation of a Standard Banking Practice for the Examination of Letter of Credit Documents. This effort is being modeled on our own publication of the same name. We continue to work with regulatory and rulemaking bodies around the world to create workable standards for the industry.

The IFSA network encompasses members, institutions, suppliers, and now government agencies and other international bodies. We realize, and we hope they share the belief that their participation enriches the conversation and multiplies the value of the net for all concerned.

We hope our presentation and our references to Kevin Kelly's _New Rules for the New Economy_ have made you proud that the IFSA is moving quickly into this connected world, while intriguing you with the possibilities that our organization can be even more of a force in the new network economy.

We'd like to leave you with one more thought from the New Rules. "In the coming era, doing exactly the right next thing is far more fruitful than doing the same thing better." We don't take this as an invitation to gamble everything on some new direction, but rather as a reminder to open ourselves to possibilities and opportunities.

Who would have thought just a few years ago that we would be co-sponsors of such a successful program of certification? There are now 482 Certified Documentary Credit Specialists from over 20 countries around the world. Or that we would sponsor a Technology Leadership Forum that would attract the likes of Cisco and SunGard?

Can we now, for example, envision the day when much of our education is offered as an e-university, expanding the educational network and reaping substantial benefits for our members.

In the networked economy, opportunity begets opportunity. And for the IFSA, with its ever-more powerful network of members, suppliers, and strategic partners, those opportunities are just beginning. ■

FEATURE

IFSA COMMITTEE REPORT: THE DOCUMENTARY LETTER OF CREDIT COMMITTEE

By Jack Kurzer, Chairman

The U.S. Chapter of the IFSA Documentary Letter of Credit Committee has as its key goals:

- Advising the IFSA Board of Directors of issues impacting documentary letters of credit, enabling the Board to establish positions regarding statements of standard banking practice or bulletins; ICC rules, position papers, opinions, or commentary; pending legislation; and the necessity of submitting *amicus curiae* briefs.

- Educating IFSA membership through support of regional letter of credit workshops, the IFSA Annual Conference, and the Certified Documentary Credit Specialist program.

- Furnishing opinions on technical letter of credit questions raised by IFSA members.

- Representing the Chapter Documentary Letter of Credit Committee to outside organizations.

- Assisting in the settlement of commercial letter of credit disputes between consenting members by offering opinions, if requested by both parties.

This year, the Committee commented on proposals contained in the ICC draft Uniform Rules & Guidelines for Electronic Trade and Settlement and its officers worked closely with the U.S. Council for International Business in furnishing commentary and proposed revisions of portions of the draft. The Committee also submitted input to those beginning work on an addendum to UCP500 to cover the use of electronic letters of credit. We were pleased to learn that the ICC Banking Commission is considering an ICC version of the Standard Banking Practice for the Examination of Letter of Credit Documents and are in the process of re-examining the IFSA publication, which covered practice in the United States and Mexico, in order to provide further input.

Among it educational programs during 2000, the committee supported letter of credit workshops in Atlanta, Chicago, New York and Las Vegas, as well as a letter of credit reimbursement workshop in New York by delivering various presentations. It also lent technical expertise regarding case studies and single-issue questions for those workshops that utilized those tools and presented a program of case studies at the IFSA Annual Conference in Orlando.

At various times through the year, the Committee commented on proposed responses to ICC Banking Commission commercial letter of credit queries. As to activities outside the IFSA, Committee Officers participated as expert panelists

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at the Institute of International Banking Law and Practice's 2000 Survey of Letter of Credit Law & Practice. The Committee addressed numerous technical letter of credit questions throughout the year as well.

The Documentary Letter of Credit Committee is one of the most active U.S. Chapter Committees in terms of the number of people involved. Due to geographical constraints and the number of members interested in participating, the Documentary Letter of Credit Committee is organized differently than most other Chapter Committees. Because it is impossible to meet or function effectively with so large a group, Local and Regional Documentary Letter of Credit Committees (Local Committees) were formed to give all interested members the opportunity to participate fully. There are currently seven such Local Committees. These committees meet on a monthly or bimonthly basis, often have guest speakers at the meetings, and run workshops and other programs. Some of the Local Committees have more than 30 active members. The Local Committees enable a larger number of IFSA members to become active, without sacrificing the efficiency of the organization. The Local or Regional Chairs sit on the U.S. Chapter Documentary Letter of Credit Committee (Chapter Committee). The balance of the Chapter Committee consists of "at large" members, selected for their experience as letter of credit practitioners with an eye towards insuring due representation of foreign and domestic, large and small, and regional members. There is a constant interchange of information between the Local and Chapter Committees.

Any IFSA member is welcome to attend meetings on the Local and/or Chapter level and the Committee encourages all IFSA members to become active. The only requirements, beyond membership, are an interest in letters of credit and a willingness to do the work involved. For example, the regional workshops are organized and run by the Local Committees, with support from the Chapter Committee.

If you are interested in participating, please have your IFSA representative contact your Local Chair. The Local Chairs are:

East Coast: Dave Pennybaker, 781-655-4231

N.Y. Metropolitan: John Baranello, 212-469-2865

Southeast: Charnell Patrick, 813-604-7045

North Central: Cheryl Talley, 312-904-4186

Northwest: John Brislin, 206-587-4761

Southwest: Peter Hofmann, 714-228-8261

Mountain States/N. California: Al Manbeian, 801-246-5369

The last regional group was formed within the last year. If any group of IFSA members is interested in forming another Local Committee, please contact the writer at 212-250-3468. You will note, for example, that no South Central Committee is currently listed. The Committee would like to involve as many members as possible.

DISCREPANCIES IN PRESENTATIONS AGAINST COMMERCIAL LETTERS OF CREDIT

By Ronald J. Mann *

Common justifications for the use of the letter of credit fail to explain its widespread use. The classic explanation claims that the letter of credit provides an effective assurance of payment from a financially responsible third party. In that story, the seller — a Taiwanese clothing manufacturer, for example — fears that the overseas buyer — Wal-Mart, for example — will refuse to pay once the goods have been shipped. The manufacturer-seller solves that problem by obtaining a letter of credit from a reputable bank. The seller knows that it has an absolute right to payment once it ships the goods — conditioned only on the seller's presentation to the bank of the specified documents. Thus, the story goes, the seller that obtains a letter of credit can rest assured that it will be paid even if the buyer would not pay voluntarily.[1]

The payment-assurance story is logical and plausible. But it rests on a line of reasoning that is largely untrue at one important and critical point: the seller's possession of an absolute right to payment. Any conversation with an executive knowledgeable about the industry would make it clear that sellers ordinarily do not

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* © 1999 by Ronald J. Mann. Roy F. and Jean Humphrey Proffitt Research Professor of Law and Professor of Law, The University of Michigan Law School. B.A. 1982, Rice; J.D. 1985, University of Texas. — Ed. I dedicate this article to Alexandra Zoë Mann. I thank the individuals who took time from their busy schedules to allow me to interview them about letter-of-credit practices; I am particularly grateful to the institutions that kindly allowed me to collect information from their letter-of-credit records. Because that information was collected subject to a variety of confidentiality requirements, I regret that I cannot thank either of those groups by name. I also thank Jim Barnes for his gracious efforts to help me arrange my site visits and Atsushi Kinami for his similarly diligent efforts to arrange my interviews with Japanese bankers.

I received useful comments from each of the commentators and several other participants at the February 2000 *Michigan Law Review* Symposium on Empirical Research in Commercial Transactions (for which this paper was prepared); I single out Douglas Baird for a particularly generous investment of time and intellectual engagement with the ideas presented in the paper. This is a shortened version of the paper presented there, which appears in 98 *Michigan Law Review* (2000). I also received useful comments on earlier drafts from Buddy Baker, Jim Barnes, Omri Ben-Shahar, Dan Keating, Rick Lempert, Vincent Maulella, Petr Oberding, Ariel Porat, Adam Pritchard, Bob Rasmussen, Mark West, and Jay Westbrook. Terry Adams provided extraordinary assistance with statistical analysis, David Murrel with graphics, Chris Killen, Catherine Leggieri, Paula Payton with transcription of the interviews, and Scott Nelson with a variety of research and logistics-related matters. Finally, I acknowledge with gratitude the generous research support of the Robert P. Tiernan Faculty Endowment Fund at the University of Michigan Law School.

For convenience, all citations to provisions of the Uniform Commercial Code without indication of date refer to the current version (that is, taking account of revisions made in 1999). Similarly, I refer throughout to INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993) (ICC Publication No. 500) as the UCP.

1. I myself have told that story. *See* RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS 215-24 (1999). For similar accounts in the standard sources, see JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDIT ¶ 1.01[3], at 1-7 (rev. ed. 1999); CLAYTON P. GILLETTE ET AL., PAYMENT SYSTEMS AND CREDIT INSTRUMENTS 560 (1996); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 20-1, at 701-02 (4th ed. 1995).

present documents that conform to the requirements of the letter of credit.[2]

Under the standard payment-assurance account, the whole transaction hinges on the seller having a reliable right to payment by the bank that issues the letter of credit. But if the seller often does not submit documents that conform to the letter of credit, then the seller has no right to payment at all, just a request for a payment that will be honored only if the buyer waives the defects in the seller's presentation.[3] And if the seller's ability to collect rests on the buyer's unconstrained choice to waive defects in the seller's presentation, then why buy the letter of credit instead of the simpler (and presumably cheaper) course of shipping the goods and simply waiting for payment from the buyer?[4] That parties to a sale transaction would ignore formal documentation requirements is not surprising, but their systematic purchase of a product conditioned on their compliance with requirements they commonly ignore does not appear rational.

Intrigued by that question, I explored the topic in detail in the summer of 1999. I gathered data in two ways. First, I visited five separate banks on-site to collect data on their letter-of-credit transactions. Although all of the banks are located in the United States, I selected institutions of sufficient variety to get a representative picture of the industry as a whole. I visited the following banks: (a) a large U.S. regional bank headquartered in the Midwest with significant letter-of-credit volume; (b) a mid-sized U.S. regional bank headquartered in the Northeast with significant letter-of-credit volume; (c) a major U.S. domestic bank headquartered in the West with worldwide letter-of-credit operations; (d) a major foreign bank, with more than one U.S. location and with worldwide letter-of-credit operations; and (e) a major U.S. bank headquartered in the Northeast with worldwide letter-of-credit operations.[5] At each bank I personally collected information on 100 transactions (50 import transactions and 50 export transactions).[6] For each transaction, I recorded a variety of information, including whether the presentation conformed to the letter of credit and, if it did

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2. For published references to the discrepancy problem, see Vincent M. Maulella, *Payment Pitfalls for the Unwary: How to Make Your Letter of Credit Work*, World Trade, Apr. 1999, at 76, 76 ("US bankers report that 50% to 60% of all letter of credit document presentations are found discrepant on first examination."); Martin Shaw, *Martin Shaw Claims There Are Better Ways to Reduce Discrepancies and That ICC Should Take Advantage of Them*, Documentary Credits Insight, Spring 1999, at 11 (reporting the views of "informed observers" that "at least 50% — some say perhaps 60% or even 70%" of presentations do not comply); *see also* UCP preface, at 4 ("Some surveys indicate that approximately fifty per cent of the documents presented under the Documentary Credit are rejected because of discrepancies or apparent discrepancies.").

3. *See* UCP art. 14(c) (authorizing issuer of letter of credit to approach applicant to seek a waiver of discrepancies in presentation).

4. For a brief description of the principal alternate methods of payment, see *infra* pages 32-34.

5. In order to obtain access to the banks' files I had to agree not to disclose the particular banks that I visited.

6. The transactions were selected to provide a random sample of recently completed transactions. Because the object of my study is to examine discrepancies in presentations, I excluded files in which the seller never presented a demand for payment under the letter of credit. Also, to avoid oversampling particular transactions, I only collected one profile from each file (even if the file included numerous presentations on a single letter of credit). At each bank I continued to select files until I had a total (not counting the excluded files) of 50 import and 50 export transactions.

not, what the discrepancies were, and the parties' response to them.[7] As a matter of practicality, I relied entirely on the banks' internal documentation of those issues. The banks, of course, could have erred in their assessment of discrepancies, but given the point of my study — understanding how parties react to discrepancies — data regarding their perception of discrepancies is directly relevant.[8]

To supplement the raw data, I also interviewed ten bankers who engage in letter-of-credit transactions.[9] Five were the bank officers who supervise the sites that I visited; the other five were officers at other banks with substantial letter-of-credit portfolios (two other large American banks, and three Tokyo-based Japanese banks).[10]

The paper proceeds in two parts. Part I describes the discrepancies that appear in those transactions, providing detail from the data I collected. The data generally support the anecdotal information that led me to conduct the study: the documents presented in the 500 transactions I examined conformed to the letter of credit only 27% of the time. The payment transactions rendered the discrepancies irrelevant because the buyer waived the discrepancies in all but one case and provided full payment for the shipment in spite of the discrepant presentation.[11]

Part II uses the data and the interviews described above to assess the possible reasons for the common use of letter of credit. In general, I make four points: (I) I reject the possibility that businesses use letters of credit out of irrational habit or custom; (II) I conclude that the classic payment-assurance story described above has some plausibility, at least in the case of exports from the United States; (III) I argue that the issuing bank's ability to verify information about the purchaser and the transaction provides the most compelling reason for widespread use of letters of credit; and (IV) I argue that in some cases governments use letters of credit as an indirect mechanism for verifying the legitimacy of the transaction.

I. Discrepancies in Letter-of-Credit Transactions

A. The Nature of the Discrepancies

As expected, the data illustrate a high rate of discrepancies: the presentations conformed to the letters of credit in only 135

7. The information — about 12,500 data points — is in a Microsoft Access database. Copies of all of the data and statistical analyses are available on request. I also collected a variety of background information: whether the letter of credit was confirmed, the countries in which the buyer and seller were located, the time when payment was due under the letter of credit, whether the letter of credit permitted multiple draws, the type of goods covered by the letter of credit, how the applicant paid the issuer for drafts on the letter of credit, whether the discrepancies suggested a contractual default, whether the discrepancies appeared to be curable, how the export-side bank responded to the documents, whether an export-side bank missed discrepancies that an import-side bank found, how waiver of discrepancies was sought, and how many days elapsed before the applicant waived the discrepancies.

8. In any event, it would not have been possible to reexamine the documents; in most cases the original documents (which often include transport documents that the buyer must use to obtain the merchandise in question) no longer were in the file.

9. Transcripts of the interviews (redacted to satisfy confidentiality requirements) are available on request.

10. The two American interviews were conducted by telephone; the Japanese interviews were conducted in person in Tokyo. The two interviews with American banks were conducted on condition of anonymity. Two of the Japanese banks were Fuji and Sumitomo; the third interview was conducted on condition of anonymity.

11. Even in that one case (Profile 457), the seller did not refuse payment entirely, but authorized a discounted payment of 94% of the amount upon which the parties originally had agreed.

(27%) of the 500 files. Although the rates did differ from bank to bank — with a high of 36% and a low of 17%[12] — conforming presentations provided the exception to a general pattern of discrepancy. The data offer considerable detail about the types of defects and the types of transactions where they frequently occur.

1. What Are the Discrepancies?

The data reveal the surprising severity of the discrepancies and, to my mind, rebut any suggestion[13] that the high discrepancy rates reported by anecdote and found in the files arise from hypertechnical document examination practices. First, more than a quarter of the presentations that contained discrepancies (98 out of the 343 files, 29%)[14] appeared to suggest a default by the seller on the underlying sales contract.[15] Moreover, although the relatively subjective problem of defective documents arose frequently,[16] a large number of the non-contractual defaults were plainly objective defects in the presentation upon which no informed document examiner could disagree. For example, 75 of the presentations (22%) did not contain a document required by the letter of credit; 62 (18%) involved a shipment later than the period specified in the letter of credit; in 48 (14%) the beneficiary presented documents late[17]; in 36 (11%) the letter of credit had expired[18]; and in 16 (5%)

TABLE ONE: TYPES OF DISCREPANCIES

Type	Number
Defective Documents	293 (85%)
Missing Documents	75 (22%)
Late Shipment	62 (18%)
Late Presentation	48 (14%)
Expired	36 (11%)
Overdraft	16 (5%)
Incorrect Shipment	14 (4%)
Partial Shipment	7 (2%)
Other	2 (1%)
Total Discrepancies	554
Total Discrepant Files	365
Files Not Examined	22
Files Examined	343

12. The conformity rates were 26% at the Midwest Bank, 17% at the Mid-Sized Northeast Bank, 29% at the West-Coast Bank, 27% at the Foreign Bank, and 36% at the Major Northeast Bank.

13. *See*, *e.g.*, Boris Kozolchyk, *The UNIDROIT Principles as a Model for the Unification of the Best Contractual Practices in the Americas*, 46 AM. J. COMP. L. 151, 160-61 (1998) (arguing that "arbitrary" judicial evaluations of discrepancies "had encouraged bad faith practices by bankers and their customers whereby meaningless defects in the documents tendered by beneficiaries were used to justify non-payment of letters of credit").

14. Although 365 files failed to comply, 22 of those files were not even examined: in those cases the applicant approved payment without the need for examination of the documents. Thus, the information that I report about the types of defaults states percentages as a share of the 343 examined files found to be discrepant.

15. I relied entirely on the banks' assessment to determine what discrepancies existed. See *supra* text accompanying note 8. I had to judge for myself, however, whether the discrepancies suggested a contractual default, something that was not always clear. I made a judgment call at the time I examined the file as to whether I thought the discrepancies collectively raised a serious doubt about the performance by the seller. Because I was interested in the frequency with which technical defects that do not go to the seller's performance appear as discrepancies, I tried to err on the side of assuming that there might be a default.

16. Defects in documents collectively constituted the largest category of discrepancy, appearing in 293 (85.4%) of the files. It is particularly difficult to determine whether defective documents suggest a contractual default, because it is rarely possible to tell from the file whether the defect reflects inadequate performance or inadequate documentation of adequate performance.

17. Unless the letter of credit stipulates otherwise, documents must be presented no later than 21 days after the date of shipment. UCP art. 43(a). It was not common for the parties to alter that 21-day period in the letters of credit that I examined.

18. In addition to the implied deadline for presentation mentioned in the previous note, each letter of credit includes an express date on which the credit expires. Any later presentation is defective. UCP art. 42(b); *see* UCP art. 44(a) (implied extension of expiration date to next business day).

the documents sought payment for an overdraft.[19]

Those discrepancies, however, do not generally suggest a serious failure of performance by the seller on the underlying sales contract; in 201 of the files (59%), the defects did not suggest a contractual default by the beneficiary.[20] Defects in those files, although often objectively indisputable problems with the presentation, do not suggest default because they involve minor documentary defects such as an inadequate signature on a bill of lading or a technical inaccuracy in describing the collateral, to name two common examples; or other defects of presentation rather than performance — late presentation (48 files, 14%),[21] expiration (36 files (11%), or overdraft (16 files, 5%).

Table Two: Discrepancies and Contractual Default	
Discrepancies Indicating Default	98/343 (29%)
Discrepancies Not Indicating Default	201/343 (59%)
Residual (Unable to Classify)	44/343 (13%)

The data highlight one structural difficulty with the letter-of-credit system. If the system worked perfectly, documentary presentations would sort transactions based on the beneficiary's performance: the documents would comply when the beneficiary had performed as agreed and the documents would not comply when the beneficiary had not performed as agreed.[22] As the data show, however, more than half of the files included defects that vitiated the beneficiary's right to collect payment, even though those same defects did not call into question the caliber of the beneficiary's performance on the contract. The poor fit between discrepancies and default suggests a problem with the letter-of-credit system.[23]

2. When Do Discrepancies Appear?

Even a casual examination of the data suggests that the discrepancies do not appear uniformly throughout the transactions. Dividing the files into import and export transactions provides the most apparent distinction. I expected that the rate of discrepancies might relate to the bank's role because a bank on the import side normally reviews documents that the beneficiary's bank has already evaluated. All other things being equal, that relationship would suggest a lower rate of discrepancies on the import side of the transaction than on the export side: the beneficiary's bank should weed out defective documents

19. In assessing those numbers, it is important to remember that many presentations contained multiple defects. Thus, the figures in the text count most of the files multiple times (because discrepant files often contained multiple defects, 554 defects in 343 examined files with discrepancies).

20. As mentioned above (*supra* note 15), I treated ambiguous cases as suggesting a default. Thus, that 59% figure is, if anything, understated.

21. Late presentation (which I did not treat as a contractual default) must be distinguished from late shipment, which I did treat as a contractual default.

22. I leave to one side the question whether the performance that the system seeks is performance up to standards set by unenforceable industry norms or performance up to the standards of judicially enforceable contractual provisions. For discussion of the distinction between those two different types of standards, see Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Value Creation Through Rules, Norms, and Institutions*, forthcoming 99 Mich. L. Rev. (2001).

23. *See* Shaw, *supra* note 2, at 11-12. Bob Rasmussen has pointed out to me that the poor fit is less relevant if you accept the idea (proposed in Part III of this Article) that letters of credit operate primarily as a device for verifying the reliability of the applicant rather than as a device for assuring payment. In any event, analysis of that problem is far beyond the scope of this Article.

TABLE THREE: DISCREPANCY RATES BY TRANSACTION TYPE	NUMBER OF DISCREPANCIES	PERCENTAGE OF DISCREPANCIES
Import Transactions	196/253	77%
Export Transactions	169/247	68%
Overall	365/500	73%

in some class of cases, so that it would not even forward the most obviously defective documents to the issuer. Similarly, the beneficiary's bank could help the seller to correct simple discrepancies. As a result of those processes, I expected that an issuer would receive a "cleansed" pool of documents to review, with a lower rate of discrepancies than it would find in documents it reviewed from the export side of transactions.

As Table Three suggests, however, my data contradict that expectation. The import-side files in fact contained a significantly *higher* rate of discrepancies (78%, 196 out of 253 files)[24] than the export-side files (69%, 169 out of 247 files). Moreover, multivariate analysis suggests that the distinction between import and export transactions was not ultimately useful in predicting the existence of discrepancies.[25]

That finding is particularly puzzling given the evidence from the data showing that export banks (at least in the United States) expend considerable effort to cure discrepancies. As I mention above, the beneficiary's banks identified discrepancies in 169 of the 247 sets of documents submitted to them. But the export-side banks obtained complying documents in 68 (40%) of those 169 files, leaving discrepancies in only 101 files. Thus, the beneficiary's banks were able to forward documents that complied in a total of 146 (59%) of their 247 transactions.

The higher concern about documentary compliance exhibited by Western banks and exporters provides the most salient explanation for those figures.[26] Comparing the

24. Because I do not have access to the files of the export-side bank that handled the import-side files that I examined, I do not know what the rate of discrepancy was when the documents originally were presented by the customers in those transactions; I know only the rate of discrepancy that persisted after processing by the export-side bank, as evidenced by the documents reviewed by the import-side bank. The rate of discrepancy identified in the text does not change significantly even if I exclude the fifteen direct presentations (as to which the "cleansing" hypothesis is not relevant). All of the direct presentations (obviously) were import transactions (because the beneficiary-seller came straight to the issuer without using an intermediary export-side bank). Excluding those transactions (five of which involved conforming documents), the import discrepancy rate would have been 78% (186 out of 238).

25. The multivariate analysis of that point was relatively inconclusive, explaining only 4% of the variance in conformance rates. Moreover, the variables that produced that explanation were so odd as to call into question the adequacy of the data on that point: they suggested that documents were least likely to conform if the issuer was in the industrial West, most likely to conform if the applicant or issuer was in industrial Asia, and somewhere in between for nonindustrialized nations. It seems clear that data from parties in other nations will be required to obtain a coherent answer on that point.

26. Indeed, more than one banker suggested that in Asia banks offer a standard product in which the seller agrees up front that its bank will not examine the documents, but instead will forward them immediately to the issuer without determining whether they comply. *See* Notes from Site Visit to Foreign Bank, at 1 (Aug. 26, 1999 — Aug. 27, 1999) [copy on file with author] [hereinafter Foreign Bank Site Visit Notes]; Notes from Site Visit to Midwest Bank, at 4 (July 28, 1999 — July 29, 1999) [copy on file with author] [hereinafter Midwest Bank Site Visit Notes]. It is not likely that the pattern that I discern is permanent. More than one banker suggested that a reverse pattern — more compliant documents coming into the United States than going out — was characteristic in earlier years. *See* Telephone Interview with Manager, Trade Service Issues, Second Major Northeast Bank (Sept. 21, 1999) [transcript on file with author] [hereinafter Second Major Northeast Bank Telephone Interview] (transcript at 5-6); Telephone Interview with Vice President and Operations Manager, West-Coast Bank (Aug. 12, 1999) [transcript on file with author] [West-Coast Bank Interview] (transcript at 4); *see also* Interview with Yutaka Abe, Senior Manager, Overseas Business

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22% rate[27] of incoming conforming documents (documents that American issuers receive from overseas export-side banks) to the 59% rate of outgoing conforming documents described in the preceding paragraph (documents that American export-side banks transmit to overseas issuers) demonstrates that concern most starkly.[28] Contrasting the domestic figures with the rate of complying documents forwarded by overseas banks further reinforces the higher regard that American banks and sellers have for producing compliant documents. Indeed, the 22% figure of incoming compliant documents, which includes both initially compliant documents and initially defective but cured documents, is less than *either* (I) the rate of initially defective documents cured by American export-side banks (40%, 68 out of 169) *or* (II) the rate of initially compliant documents submitted by exporters in this country (32%, 78 out of 247).

Table Four: Import and Export Compliance

	Number of complying files	Percentage of Complying files
Import Compliance Rate	57/253	23%
Total Export Compliance Rate	146/247	59%
Initial Compliance (by Customers)	78/247	32%
Cured (by Bank)	68/169	40%

Although a variety of considerations doubtless contribute on a country-by-country basis to the differing rates of attention to discrepancies, the interviews with bankers suggest that the relative reliability of the Western commercial and banking systems is the leading general cause. They explain it as follows: the party sending goods into the United States tends to worry less about the likelihood of misconduct by the United States purchaser than a corresponding United States exporter considering the likelihood of misconduct by an overseas purchaser.[29] Indeed, the same idea supports the notion that letters of credit on

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Division, The Fuji Bank, Limited, Tokyo (June 15, 1999) [transcript on file with author] [hereinafter Fuji Bank Interview] (transcript at 3) (suggesting that discrepancies formerly were much higher in Japanese import transactions than they are now).

27. That rate is simply the flip side of the 78% discrepancy rate in import-side transactions. I also should emphasize that the rate differs considerably from bank to bank. In my data, it varied from 72% to 82%. One other American banker with a large portfolio told me that the discrepancy rate in his import portfolio was only 60%. Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 2). Furthermore, the identity of the bank was a significant predictor variable in my multivariate analysis both for the likelihood of conformance and for the likelihood that defects would be cured. Because I did not collect information about the customers, I do not have data about variation in discrepancy rates among customers, but anecdotal evidence suggests that the rate varies significantly from customer to customer. For example, one banker explained that although some of his customers submitted documents that complied 99.9% of the time, others submit documents that are discrepant 90% of the time. Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 15); *see also* Maulella, *supra* note 3 ("[S]ome exporters report that over 95% of the document presentations are in order; other exporters report a 95% frustration rate.").

28. Again, because I do not have access to the files of the export-side banks in my import-side transactions, there always is the possibility that those banks had a systematically different view of the rate of discrepancy in the documents that I transmitted. *See infra* note 32 (discussing anecdotal evidence related to document-examination practices in Japan). To make any sense of the practice, however, I have to use some baseline for compliance and given data collected only from United States banks it makes sense to use United States document-examination practices as a baseline. Responding to that concern, I hope to collect similar data in Japan in the coming year.

29. *See* West-Coast Bank Interview, *supra* note 26 (transcript at 7) ("Our whole setup is based on not sending documents out of here which a bank overseas can find discrepancies with . . . because we know that in some areas of the world it's a tendency to find discrepancies for the sole purpose of coming up with a discount."). Interestingly, one banker suggested that banks follow country-by-country conditions so closely that they step up the vigilance of their document checking in countries (such as Asian
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shipments into the United States serve a different function (unrelated to the reliability of the United States buyer[30]) from the function that they normally serve on shipments out of the United States (where the reliability of the overseas buyer might be central to the use of the letter of credit).[31]

That explanation does not ring true with all countries in which trading partners of Western companies are located, but it probably covers many less-developed countries with relatively unstable economic conditions and undeveloped legal systems. Together, those conditions can make the reliability of the letter of credit less crucial for the party selling goods into the West than for the party selling goods out of the West. Accordingly, the Western exporter sending goods overseas (and its bank) will work harder to ensure that it has complied with the conditions of the letter of credit than an overseas exporter sending goods into the West (and its bank).[32]

Indeed, the interviews suggest that in many countries the export-side bank transmitting goods into the United States will not even bother to examine the documents before forwarding them.[33] Thus, in those cases the bank makes no effort at all to cure discrepancies, a far cry from the apparent American banking practice of scrutinizing documents and curing about 40% of the discrepant documents submitted by their customers.[34]

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countries in recent years) that appear to be undergoing particular crises. *See* Telephone Interview with Vice President, Bank Number 1 (Aug. 6, 1999) [transcript on file with author] [hereinafter Midwest Bank Interview] (transcript at 12-13). As he explained, although the banks in the country under stress might honor discrepant documents 99% of the time under normal conditions, "in hard times they might reject half of them." *Id*. (transcript at 13).

30. *See infra* section III(C)(2).

31. *See infra* section III(C)(1). I thank Bob Rasmussen for pushing me to see that point.

32. Some loose evidence of the less stringent document-review practices overseas seems to be apparent from the perception of Japanese banks that there is a very low rate of discrepancy in the documents they receive from their clients in export transactions. *See* Interview with Deputy General Manager (Special Assignments), Deputy General Manager, and Senior Manager, Anonymous Japanese Bank, Tokyo (June 17, 1999) [transcript on file with author] [hereinafter Anonymous Japanese Bank Interview] (reporting a discrepancy rate on export transactions of only 35%); Interview with Hiroshi Higuma, Assistant Manager, Corporate Planning Dept., The Sumitomo Bank, Limited, Tokyo (June 21, 1999) [transcript on file with author] [hereinafter Sumitomo Interview] (transcript at 3) (reporting a discrepancy rate on export transactions of only 15% {albeit after cure efforts at the branch-bank level}).

Those rates suggest to me that a considerably different standard for document examination prevails in Japan than the one that prevails in American banks reviewing documents received from Japan. As it happens, my information on documents coming into this country from Japan (4 of the 13 Japan-based import transactions {31%} included complying presentations) is too limited to support any inferences about those practices. Moreover, even if I examined Japanese transactions at a Japanese bank it would not provide direct evidence of the relative rigor of their document examination practices. The most obvious test would require using American-trained examiners to study a set of documents also submitted to Japanese examiners; that type of test is not practical with the logistical resources available for my research.

33. *See supra* note 26 and accompanying text (mentioning references to that practice).

34. Because I did not examine export-side transactions in the files of any overseas banks, I have no direct observations of their effort (or lack of effort) to cure defective documents. The most that I can do is to examine the frequency with which defects are cured in the dataset that I collected. On that point, the data again appear to be too limited to provide a robust explanation for the pattern of cure efforts. The multivariate analysis explained only 5% of the variance in conformance rates, which is not surprising given the location of all of my transactions at least partially in the United States. Moreover, as with the data related to the existence of discrepancies (discussed *supra* note 25), the analysis suggested no consistent distinction between industrialized and nonindustrialized nations.

Given the difficulties with making sense of what the data suggest related to any of the geographic variables, it is useful to look briefly at other possible explanations. For example, one banker suggested that price changes that make opportunism more beneficial occur more commonly with commodities shipments (which characterize transactions going out from the United States) than on manufactured-goods shipments (which characterize transactions coming into the United States).[35] A thorough analysis of that question would require considerably more specific data than I collected, but the data do suggest that the type of goods is relevant in some way, because the type of good was the most powerful explanatory variable of the willingness of an applicant to submit documents with curable defects: curably defective documents were particularly associated with garment transactions and particularly unlikely in transactions involving durable manufactured goods.[36]

Another banker pointed to the differing types of typical credits for the two sets of transactions: incoming shipments into the United States are much more likely to be a part of substantial long-term relationships (as to which discrepancies are less important)[37] while outgoing shipments from the United States are much more likely to be "one-off" transactions where the shipper enjoys limited relational protections.[38] That explanation cannot easily be assessed without data collected from the files of the applicants and beneficiaries about their relations with their customers, data not included in the existing dataset.

In the end, however, it should not be surprising that the objective variables that I collected are so ineffective as predictors of discrepancy. Nobody suggests that beneficiaries or their banks intentionally submit documents with discrepancies. Rather, discrepancies are most likely to arise simply from a general inattention to detail. And, unless beneficiaries in their banks can develop cognizably distinct levels of inattention to detail based on features of a particular transactions, it should not be surprising that the existence of a mistake in any particular case should be almost random. The point can be overstated, because the data do strongly suggest that there are some country-by-country effects. But it seems clear that those effects cannot be understood from a dataset collected from a single country. Thus, although the dataset seems adequate to suggest a high level of discrepancy (the principal point of this article), it seems clear that data from another country will be necessary to learn more about the pattern within which discrepancies appear.

35. *See* Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 6).

36. *See infra* notes 86-87 (discussing special characteristics of garment transactions).

37. As suggested above, *see supra* text accompanying nn. 30-31, that thesis gains some support from the analysis in Part II(C)(2), which outlines several country-specific reasons why export transactions from the United States might use letters of credit in continuing relationships, even though there is good reason to think that exporters generally use letters of credit less often in continuing relationships, *see infra* pages 34-35 (discussing the possible inverse connection between letters of credit and the strength of the buyer-seller relationship).

38. *See* Midwest Bank Interview, *supra* note 29 (transcript at 11-12); *see also* Interview with Vice President and Manager, International Operations, Bank Number 2 (Aug. 5, 1999) (location not disclosed to protect anonymity) [transcript on file with author] [hereinafter Mid-Sized Northeast Bank Interview] (transcript at 12) (explaining that relational considerations are the prime motivation for buyers to waive discrepancies in documents presented for payment on letters of credit).

B. Waiving Discrepancies

Because the frequency of discrepancies motivated this study, the information described above was not entirely surprising; it confirmed anecdotal descriptions with an added wealth of detail that serves as fodder for new speculation. The response to the defaults was the most surprising. I expected to find that applicants seize on the discrepancies in a significant number of cases — including many cases in which the discrepancies did not suggest a contractual default — as a basis for delaying or withholding payment to the beneficiary on the letter of credit.[39]

The data suggest that my expectation was wrong: even when the documents suggest a default on the underlying contract, applicants almost always waive the discrepancies and permit full payment to the beneficiaries under the letter of credit. In the 365 files with discrepancies, the applicants waived the discrepancies and permitted full payment in every file but one. And in that file the applicant did not refuse payment, it permitted payment of 94% of the agreed amount.[40] Thus, in the 500 letter-of-credit transactions examined, the applicant never refused payment on the letter of credit.[41] The data doesn't vary from assertions by bankers involved in the industry; every interview subject with whom I spoke about payment refusal claimed that applicants would refuse payments in less than one percent of the discrepant files.[42]

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39. My expectation was supported by the views of the drafters of the UCP, who report that "[s]ome surveys indicate that approximately fifty percent of the documents presented under the Documentary Credit are rejected because of discrepancies or apparent discrepancies." UCP preface, at 4. In hindsight I can make that statement correct by interpreting the reference to "reject[ion]" to mean only a determination of discrepancy, but before I did this study I interpreted it to mean rejection in the sense of refusal to accept.

40. Profile 457. That transaction included some defects that did not demonstrably indicate contractual defaults: expiration, late presentation, a missing document (one counterpart of a purchase order), and a defective document (technically inaccurate shipping terms). It also included, however, a late shipment, which normally would reflect a default on the underlying contract.

41. In all of my files, the banks immediately paid upon receipt of the waiver. It is, however, the view of the industry that the bank is not bound by the waiver issued by its customer the applicant. *See* ICC, MORE QUERIES AND RESPONSES ON UCP 500: 1997, at 14 (1997) (Response 254) ("In the event that discrepancies are observed in a presentation of documents and the issuing bank [gives adequate notice of the discrepancies], the issuing bank is under no obligation to take up the documents, even if a proper waiver of the discrepancies is received from the applicant."); ICC, MORE QUERIES AND RESPONSES ON UCP 500: 1997, at 28 (1997) (Response 267) ("The receipt of a waiver from the applicant, either direct or via the beneficiary, does not bind the issuing bank to accept the documents. The decision of whether or not to comply with the waiver is one for the issuing bank to decide in its sole judgment."). It appears that the only substantial reason that a bank would decline to accept such a waiver would be doubts about its ability to obtain reimbursement from the applicant. *See* Second Major Northeast Bank Interview, *supra* note 26 (transcript at 6-7).

42. *See* Foreign Bank Site Visit Notes, *supra* note 26, at 1 (estimating three refusals each year out of 10,000 presentations, for a rate of .03%); Telephone Interview with executive from Bank Number 5 (Oct. 8, 1999) [transcript on file with author] [hereinafter Major Northeast Bank Interview] (transcript at 10) ("I would have said it was a small fraction of one percent."); Telephone Interview with Vice President, Technical Consultant for Global Trade Services, Major Midwest Bank (July 19, 1999) (interview conducted on condition of anonymity) [transcript on file with author] [hereinafter Major Midwest Bank Telephone Interview] (transcript at 7) ("I would say ninety-nine percent of the documents [that are discrepant are paid]."); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 5) ("[A]t the end of the day ninety-nine point nine percent of the documents they present, whether they carry discrepancies or not, are paid."); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 17) (banker who does 100,000 transactions a year suggesting that "I would be very comfortable in just guessing [that the number of rejected documents per year is] less than a hundred. It may be less than ten."); West-Coast Bank Interview, *supra* note 26 (transcript at 7) (agreeing with my expectation of finding only one or two refused presentations in my five-hundred file study).

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Even more surprising than the rate of waiver was how quickly applicants waived defaults. Several bankers suggested that applicants — even if they ultimately permit payment — commonly delay payment for a significant period of time to reflect dissatisfaction with the beneficiary's performance in the transaction. But the data suggest that applicants generally waived promptly. Of the 196 import files with discrepancies, the applicant in more than half of the files — 103 (53%) — waived the discrepancies within one business day after the issuer contacted the applicant about the discrepancy. By one week after the issuer contacted the applicant, they waived discrepancies in 165 (84%) of the files.[43] By four weeks after the issuer contacted the applicant, only six files (3%) remained unaccepted.

As a practice of accommodation in transactions among long-time partners, the rate and pace of waivers might seem commonplace. But as we see below, many letters of credit are used in one-shot transactions or other contexts where relational constraints have less force, precisely because of the lack of confidence in the relationship.[44] In those contexts, that rate of waiver seems truly startling.

III. Why Letters of Credit?

The data presented in Part I display an odd and puzzling picture. Commercial parties pay substantial fees to banks to use letters of credit in their transactions.[45] The beneficiaries then usually submit documents that do not conform — which jeopardizes their *right* to payment under the letter — but the applicants then almost universally waive the defects with startling haste, notwithstanding the frequent contractual defaults displayed on the face of the documents presented by the seller.

The remainder of this Article offers some tentative explanations for that pattern. Given the worldwide use of the commercial letter of credit, and its use in a wide variety of contexts, no single explanation captures all of the motivations for its use. The information collected in this study does, however, allow me to make some progress in understanding the transactions. Thus, this Part of the Article begins in Section A by rejecting the idea that businesses use letters of credit because of some sub-optimal path dependence or mistake. Section B then critically assesses the payment-

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The pattern appears to be similar in Japan. *See* Anonymous Japanese Bank Interview, *supra* note 32 (transcript at 7) (suggesting rejection of about ten documents out of a monthly volume of 17,000 transactions); Fuji Bank Interview, *supra* note 26 (transcript at 9) (reporting rejection of documents or reduction of amount to be paid in about ten out of every 18,000 transactions); Sumitomo Interview, *supra* note 32 (transcript at 4) (suggesting rejection of ten documents out of a monthly volume of one thousand noncomplying transactions).

43. One week (five business days) serves as a rough guide of a timely response, because the issuer generally needs to respond to the bank that presented the documents within seven business days after it receives the documents. *See* UCP art. 13(b) (calling for a response within "a reasonable time, not to exceed seven banking days"). If the issuer takes two business days to examine the documents, that would leave five business days for the applicant to decide whether it wishes to waive any discrepancies without preventing the issuer from transmitting a timely acceptance of the documents. Of course, if the issuer does not receive a waiver by the seventh business day, it still can pay later, by sending a notice rejecting the documents on the seventh business day, followed by a later notice accepting the documents with discrepancies. For a thorough discussion of typical practice, see International Finance Services Association, *Statement of Practice: Reasonable Time for Examination & Notice of Dishonor*, in THE 1999 ANNUAL SURVEY OF LETTER OF CREDIT LAW & PRACTICE 311 (James E. Byrne ed.) .

44. *See infra* pp. 34-35 (discussing reasons why parties select letters of credit instead of other payment mechanisms).

45. *See* MANN, *supra* note 1, at 217.

assurance story, concluding that it cannot provide a general explanation, but likely continues to play some role, especially in relation-deprived uses of letters of credit. Finally, Section C offers two new justifications for the use of letters of credit, both of which turn on the ability of the issuer to verify to a third party some present or future fact about the buyer or the transaction. None of the explanations qualifies as a general, unified explanation for all of the transactions in which businesses use commercial letters of credit. Taken together, however, they provide a general picture of plausible motivations for much of the universe of commercial letter-of-credit transactions.

A. The Road Not Taken: Irrational Habit and Path Dependence

Perhaps no rational explanation elucidates the puzzle presented by the high discrepancy rates: businesses use letters of credit not because of the benefits they provide, but because of a combination of practical factors such as a failure to understand how letters of credit work in practice, along with some habit of usage. To put it more directly, that perspective suggests that businesses buy letters of credit from banks by mistake — because they always have — and that if they fully understood the costs and benefits of letters of credit they would use alternate payment systems.

The mistake story cannot be rejected out of hand: businesses cannot have perfect comprehension of everything that they do and surely they occasionally enter into transactions on terms attributable to imperfections in their understanding.[46] But two factors make me doubt the general applicability of the mistake theory.

First, the sophistication of the parties involved reduces the credibility of the mistake theory. Many of the users of letters of credit are large and sophisticated companies. In the study, for example, I reviewed the files of several prominent discount retailers and department stores that obtained letters of credit to pay their overseas suppliers. And they did not use letters of credit occasionally or haphazardly; on the contrary, the files clearly documented that those companies have large letter-of-credit relationships covering a substantial portion of their sales activity.[47] Absent some new evidence, it seems implausible that those companies would organize such a large number of transactions in a way that systematically, repeatedly, and pointlessly increases the cost of the transactions.

The larger framework of the institutions for providing payment in cross-border sales transactions also casts doubt on the mistake explanation, because it shows that businesses make a conscious and deliberate choice to select the letter of credit from among a variety of competing payment institutions. Generally, sellers and buyers can choose from four significantly different methods of providing payment in cross-border transactions. Ranging

46. For comments to that effect in this context, see Fuji Bank Interview, *supra* note 26 (transcript at 13-14) (discussing the lack of sophistication by smaller companies doing international trade and explaining that "there's a perception for the Japanese company that the LC is very credible, reliable. And once they receive an LC they feel like they have completed the transaction."); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 15, 17) (suggesting that customers focus on the fact that their letter-of-credit transactions get paid rather than the risk of nonpayment).

47.The size of such a relationship was particularly evident at two of the banks (Banks 1 and 4), whose file-numbering systems included a separate filing system — with separate numbers and file locations — for the transactions of two prominent retailers that are their largest letter-of-credit customers. Each of those customers provided, on a conservative estimate, more than 20% of the bank's letter-of-credit work.

from most favorable to the seller to most favorable to the buyer, the options include prepayment, payment by letter of credit, payment by documentary collection, and open account.[48]

The first (prepayment) and the last (open-account) are the simplest and cheapest, but create the greatest possibility for opportunistic misconduct by the trading partner, because those transactions require one party first to perform completely, trusting the other party to respond by performing in turn.[49]

In between those two polar choices lie two intermediate choices, the letter-of-credit and documentary-collection transactions. Those transactions intertwine the performance of the parties, with each party taking substantial steps toward performance before either party completes its activities. In the letter-of-credit transaction, as discussed above, the seller waits to ship until it receives a letter of credit issued on behalf of the buyer. The buyer, in turn, withholds payment until it receives adequate evidence that the shipment has occurred, as shown by the documents required for payment under the letter of credit.

The documentary-collection transaction (or, commonly, a collection transaction) is another intermediate option, cheaper but less protective of the seller than the letter-of-credit transaction.[50] The seller ships the goods without any previous action by the buyer to effect payment, but a transport document transmitted through banking channels covers the goods. In the typical (though not universal) way of arranging the transaction, the buyer cannot obtain the document of title, and thus cannot obtain the goods that the document covers, until it pays the bank for the goods.[51] The collection transaction favors the seller less than the letter-of-credit transaction because the buyer has no obligation to take up the documents.[52] Hence, the buyer might not be able to get the goods without paying for them, but the seller cannot force the buyer to pay; if the buyer chooses not to pay, that the seller must deal with goods that it has shipped to an

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48. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 6-7).

49. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 6).

50. For a more detailed summary, see MANN, *supra* note 1, at 457-66. For descriptions by a banker, see Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 6-7). Because two of the banks that I visited maintained records on documentary-draft transactions at the same sites as they maintained letter-of-credit records, I collected information on documentary-draft transactions at those sites (50 records at each bank for a total of 100). Those records are in the same database as the other data.

51. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 7 ("If the documents are titled properly then no pay, no documents for merchandise."). Two common variations use nonnegotiable documents of title. In one, the goods are consigned to the collecting bank; that has substantially the same effect as a negotiable shipment, because the buyer usually must pay to acquire the goods. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 8-9). The other common variation, particularly in shipments by air, uses nonnegotiable documents and ships directly to the buyer. In that transaction the buyer can obtain the goods without paying the bank for them. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 8). Thus, that transaction provides the seller little more protection than the open-account transaction discussed above. The transactions proceeded in that less protective fashion in 33 out of the 96 (34%) collection transactions for which I could examine the relevant documents.

52. *See* Midwest Bank Interview, *supra* note 29 (transcript at 8) ("[A] collection raises the obligation of absolutely nobody to do anything that they don't want to do."); West-Coast Bank Interview, *supra* note 26 (transcript at 13) ("[Y]ou're completely putting yourself at the mercy of that party [*i.e.*, the overseas buyer].").

overseas location, with no local buyer for them.[53] The collection transaction provides a more secure option than an open-account transaction (where the buyer can get the goods without paying for them), but not by much. Collection transactions, however, cost much less than a letter-of-credit transaction, with bank fees typically fixed in the range of $100-$300, regardless of the size of the transaction.[54]

The available information makes it clear that parties can realistically and freely choose among those four payment systems. Significantly, the choice suggests that the letter of credit is not the automatic response of a custom-bound industry. Businesses don't use letters of credit indiscriminately out of habit. Rather, they select them for transactions in which they do not have a good enough relationship with the overseas party to justify engaging in collection or open-account transactions. As one banker put it, "there has to be trust between the two before you send the documents on collection."[55] Indeed, the best information I found indicates that businesses use letters of credit in only about one-fifth of cross-border sale-of-goods transactions coming into or out of the United States.[56]

The relatively low rate of use certainly does not suggest a market populated by businesses that buy letters of credit for no good reason. On the contrary, it suggests a market in which businesses use cheaper methods of payment whenever the protections of the letter of credit fail to justify the cost, and, in which they select the letter of credit only when they want its security. Generally, it suggests, businesses use letters of credit in one-shot transactions where relational protections are inapplicable, or in the opening stages of a potential long-term relationship, before relational constraints become effective.

53.*See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 7). Buyers declined to pay the banks in 12 out of the 100 collection transactions. That 12% non-payment rate is striking compared to the non-payment rate in the letter-of-credit transactions of less than one-tenth of one percent. The higher non-payment rate would not surprise the bankers to whom I spoke about collection transactions. *See, e.g.*, Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 12) (discussing difficulties of obtaining payment in collection transactions); West-Coast Bank Interview, *supra* note 26 (transcript at 13-17) (same).

54.*See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 15-16) (discussing the different types of charges in letter-of-credit transactions and collection transactions); West-Coast Bank Interview, *supra* note 26 (transcript at 12) ("[O]bviously the cost of a letter of credit is very much higher than a collection. Our collection fees are low — very low in comparison. [Collections a]re not a big money maker and they're looked at more as a service to a customer instead of an actual money-making product."); *see also supra* note 45 (discussing fees for letters of credit). [My estimate of the fees for collection transactions is based on my review of the files in my database.]

55. Midwest Bank Interview, *supra* note 29 (transcript at 8); *see* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 19-20) (discussing reasons why parties choose collection transactions instead of letters of credit); West-Coast Bank Interview, *supra* note 26 (transcript at 12) ("[T]he only reason [collection transactions] exist is because there's a great deal of . . . trust between the parties concerned or in some cases people just would rather take the risk than pay the initial letter-of-credit fees, which can get pretty expensive."). For a similar view from a knowledgeable academic, see John F. Dolan, *Letters of Credit: A Comparison of UCP 500 and the New U.S. Article 5*, [1999] J. Bus. L. 521, 528 ("Thus the commercial letter of credit arises most often between parties that know little of each other or are in distant markets and when at least one party is located in a developing country.").

56. One banker reported to me two sources of data in his possession. The data that he considered more reliable suggested that 13% of such transactions were done by letters of credit, 72% by open account, 4% by documentary collections, and 2% by cash in advance. Another source (that he considered less accurate) reported 29% letters of credit, 52% open account, 12% cash in advance, and 7% documentary collections. *See* Interview with Group Vice President and Head of Trade Services Product Management, International Trade & Advisory Group, Bank Number 4 (Sept. 2, 1999) (location not disclosed to protect anonymity of bank) [transcript on file with author] [hereinafter Foreign Bank Interview] (transcript at 13). Whichever figures are closer to reality, however, both figures suggest that letters of credit are not used routinely without regard to cost.

B. The Classic Story: Assurance of Payment

The payment-assurance story provides the classic understanding of letters of credit. In that story, the key benefit offered by the letter of credit is a right of payment enforceable against the issuer. That right largely removes the risk of the open-account transaction. Put another way, the letter of credit exchanges the typically uncertain obligation of a buyer to pay for something received for an absolute obligation of a financial institution.

Part I demonstrates that the payment-assurance method fails to explain the general use of letters of credit. The payment-assurance story makes sense only if the seller generally expects to use the letter of credit to force the issuer to pay. But as the data suggest, an experienced seller would understand that it usually cannot force payment from the issuer, because it usually will not submit documents that comply with the letter of credit. Thus, in many if not most cases, the seller's right to payment will depend entirely — at least as a legal matter — on the grace of the buyer in waiving the discrepancies in the documents submitted by the seller.

To be sure, a weaker version of the payment-assurance story may supply a better fit with a high rate of discrepancies. For example, if letters of credit cost little, if sophisticated sellers expect buyers to renege and try to withhold payment quite rarely, and if it is expensive to submit documents that comply, then rational sellers might use letters of credit generally, but accept a high rate of discrepancy, just to keep the letter of credit in reserve for the rare cases in which buyers try not to pay.

Indeed, the information I collected about cure efforts suggests that I incorrectly assumed that high discrepancy rates are inconsistent with some payment-assurance rationale. Most obviously, the existence of substantial cure efforts, illustrated by my discussion above of American export-side banks,[57] indicates that exporters and the banks that serve them see significant value in producing documents that comply. On the other hand, the size of the letter of credit is not a useful predictor of any of the dependent variables that I studied: the rate of discrepancy, the rate of submission of documents with curable defects, or efforts to cure. If compliance of the documents was substantially significant, then parties should be trying harder to produce compliant documents in larger transactions.[58]

The pattern of cure efforts underscores that correlation. On the one hand, although again based on the limited data in the study, the largest cure efforts appear in the context — exports from the United States to overseas buyers — in which parties generally use letters of credit to compensate for the absence of strong relations between the buyer and the seller. Conversely, cure efforts seem much weaker on imports into the United States. Again, generalizing with caution, concerns about the reliability of the American importer might be less substantial.[59] Finally and most interestingly, the single context in which I saw parties dispensing entirely with cure efforts — purchasing letters of credit sold at a lower price and processed without any export-side review of the documents at all — involves transactions importing goods

57. *See supra* pp. 26-29.

58. The size of the transaction was significant in the univariate analysis, but the correlation was not monotonic (that is, the rate of conformance and efforts to cure did not increase with the size of the transaction). Moreover, although size of the transaction was included in the multivariate analysis, it was not a useful predictor for any of the three dependent variables.

59. I offer in section II(C)(2) a reason for letter of credit usage independent from those relation-based concerns.

into the United States.[60]

To be sure, I cannot credit the payment-assurance effect as anything but a relatively weak factor. The large frequency of easily curable defects in the files that I examined suggests that it cannot be all *that* important to provide complying documents. Defects that the bank can cause the seller to cure generally could have been avoided more cheaply in the first place. To use a common example from the files that I examined, surely a seller would save money writing a draft correctly the first time rather than writing a defective draft, paying the bank's discrepancy fee,[61] and then taking the time and effort a week later (after prodding by the bank) to produce a compliant draft. Even experienced and careful sellers would make mistakes from time to time, which banks would catch, but a universe in which banks can cure defects in more than one-fourth (27%, 68 out of 250 export files) of the presentations made to them is not a universe populated by diligent sellers trying hard to avoid obvious mistakes.

In sum, I believe, again based on only limited data, that assurance of payment must remain part of the story of letters of credit, but that it provides an incomplete reason for their use. To tell the whole story, we must look also for some other benefit to the seller that obtains a letter of credit.

C. The Letter of Credit as a Verification Institution

If the letter of credit adds real value to the underlying transactions, and if a right of payment enforceable against the issuer cannot explain the value, then the value must come from something else provided by the bank that issues the letter of credit on behalf of the buyer. The points of difficulty lie in identifying precisely what the bank verifies and why the parties need the bank to verify it. Given the limited scope of the data collected to date (which includes no information about the nature of the customers or their relations with the banks or their transaction partners), I can only speculate at this point. Still, I can identify two separate justifications for use of the commercial letter of credit as a verification institution: verifying to the seller the likelihood that the buyer will pay and verifying to the government the legitimacy of the transaction.

1. Verifying the Likelihood that the Buyer Will Pay

In my view, the implicit verification of the applicant's reliability and probity that the issuer makes when it issues the letter of credit generally explains the common usage of letters of credit. Structurally, that verification furnishes a classic example of reputational intermediation: the applicant/buyer "rents" the issuer's reputation to allow the beneficiary/seller to verify the credibility of the applicant/buyer's promise to make payment when the seller ships the goods.[62]

Central to that arrangement, of course, is the availability of a reputational sanction against the bank that issues the letter of credit. On

60. *See supra* note 26 (discussing that product as available to businesses shipping goods from Asia to the United States); *infra* note 103 (same).

61. At the banks that I visited, discrepant presentations universally were assessed a fee, which ranged from a low of $25 to a high of $75.

62. The classic explanation of reputational intermediation appears in Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 618-21 (1984) (discussing reputational intermediation in the issuance of securities); *see also* Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEORGETOWN L.J. 2225, 2269-71 (1999) (generalizing that idea).

that score, I take it as given that banks generally have a strong reputational interest in their letter-of-credit businesses.[63] For that explanation to make sense, however, I need to examine three separate characteristics of the transactions in which the letter of credit is used: the relative ease of verifying the reliability of a foreign bank as opposed to a foreign trading partner; the plausibility of treating a bank that issues a letter of credit as vouching for the future performance of its client the applicant; and the information that the bank is in a position to provide. I address those problems in turn.

a. Why Evaluate the Bank Instead of the Buyer? The bank helps to solve the information problem that faces a seller of goods to a foreign buyer when the seller attempts to estimate the likelihood that the buyer opportunistically will attempt to withhold payment in the transaction after the seller ships the goods. Efforts to assess the reputation of the buyer directly often will be expensive and ineffective.[64] For one thing, the buyer's location in a foreign country makes it more costly to collect information than if the buyer were located in the same country as the seller.[65] As one banker put it, letters of credit are not as useful in same-country transactions because "it's easier to get a credit report cheaper than to force somebody to give them a letter of credit."[66] Also, even if the information is available, it may be less reliable to the seller than information collected in the seller's own country.[67] Similarly, differences in accounting systems from country to country generate difficulties in the assessment of any objective financial information that the seller might obtain. Moreover, the sheer number of potential trading partners worldwide makes the task of maintaining any knowledge of financial strength and probity daunting at best.

Although those problems create similar difficulties in the assessment of the financial strength and credibility of foreign banks, foreign parties can much more easily evaluate foreign letter-of-credit banks than they can evaluate foreign trading partners.[68] For one thing, the universe of reputable letter-of-credit banks is much smaller than the

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63. The best anecdote I heard about the significance of bank reputation in the letter-of-credit context involved Chinese banks that were barred by the Chinese government from using hard currency to honor previously issued letters of credit. Notwithstanding the plenary control of the government over bank activities in mainland China, the officers at those banks still used a variety of arrangements — offsets against overseas funds and the like — to do the best they could to provide timely payment on the letters of credit that they had issued. *See* Foreign Bank Interview, *supra* note 56 (transcript at 3-4).

64. For a theoretical discussion of reasons why it is difficult for many countries to develop effective systems for disseminating credible information about their businesses, see Bernard S. Black, *The Legal and Institutional Preconditions for Strong Stock Markets: The Nontriviality of Securities Law* (unpublished Sept. 1999 manuscript) [copy on file with author].

65. *See* Foreign Bank Interview, *supra* note 56 (transcript at 4) ("If you're selling to somebody outside the United States it's very difficult to get good credit information so you try to go to [Dun & Bradstreet] or whatever you can. But, you get very sketchy information."); Major Northeast Bank Interview, *supra* note 42 (transcript at 7).

66. Midwest Bank Interview, *supra* note 29 (transcript at 5).

67. *See* Foreign Bank Interview, *supra* note 56 (transcript at 5) (pointing out that Dun & Bradstreet collects information on foreign companies, but suggesting that "companies in another country are not so concerned [as American companies] about [the validity of the information that they provide Dun & Bradstreet]").

68. *See* Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 14) ("When we're asked to confirm a credit — we're making that decision for the most part based on the bank. . . . We understand the bank and we know the bank and we have a relationship with the bank and we may not have a relationship or know the importer.").

universe of trading partners: in most countries only a few banks participate in the global letter-of-credit arena. Thus, parties can obtain much more information about those banks.[69] Second, large banks in the relevant markets more often follow internationally comprehensible accounting conventions than the great mass of trading businesses in the foreign country; thus, analysts in the seller's country can more easily assess information about the buyer's bank than information about the buyer itself.[70] Third, especially for smaller countries with less stable financial conditions, regulatory authorities more often provide close supervision of the affairs of banks than they do of the affairs of the large number of trading businesses in the country.[71]

Taken together, those conditions all work together to make it considerably easier for analysts in the seller's country to form a confident opinion of the reliability of the buyer's bank than of the buyer itself. That opinion can be in the formal nature of a published rating[72] or it can be less formal periodic updates that a local bank provides its larger customers[73] or even episodic comments about banks involved in particular transactions.[74] Regardless of the opinion's form, parties involved in letter-of-credit transactions maintain constant vigilance over the activities of the foreign banks with whom they deal,[75] and that vigilance seems much more effective than any comparable

69. *See* Foreign Bank Interview, *supra* note 56 (transcript at 5) ("[T]here's an awful lot publicized. There's a lot you can read in *The Economist* or other periodicals, magazines, things about the creditworthiness of various banks and the countries that they're in.").

70. *See* Foreign Bank Interview, *supra* note 56 (transcript at 5-6) ("Banks are much more standardized in the way that they do their accounting. . . . [T]hey're also going to be doing a lot of international activities so there's going to be a lot of pressure on them from correspondent banks they are doing business with to state their numbers according to generally accepted accounting principles.").

71. *See* Foreign Bank Interview, *supra* note 56 (transcript at 5) ("[I]t's also quite true that countries are very sensitive — or at least traditionally very sensitive — to keeping all of their banks running. So, as long as the country itself is in good condition it's very unlikely that a bank will go bankrupt. . . . [Y]ou can't depend on that completely but it's a much better risk than a corporate risk."). That observation does not apply, of course, to the United States and other countries sufficiently confident in their financial systems to allow bank failures to provide market discipline. For discussion of some of the difficulties that regulators face in permitting bank failures, see Curtis J. Milhaupt, *Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?*, 77 Wash. U. L.Q. 399 (1999); Geoffrey P. Miller, *Is Deposit Insurance Inevitable? Lessons from Argentina*, 16 Int'l Rev. L. & Econ. 211 (1996).

72. *See* Foreign Bank Interview, *supra* note 56 (transcript at 6) (discussing such a publication); Midwest Bank Interview, *supra* note 29 (transcript at 6) (discussing ratings agencies that rate foreign banks).

73. *See* Foreign Bank Interview, *supra* note 56 (transcript at 6) (discussing the availability of such updates).

74. *See* Foreign Bank Interview, *supra* note 56 (transcript at 6) (discussing the bank's willingness to provide that information); Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 18) (describing requests for such information). The importance of reliable information is underscored by the common practice of an American bank seeking confirmation from another American bank of a letter of credit issued by an overseas bank with which the first American bank is not adequately familiar. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 18-19); Midwest Bank Interview, *supra* note 29 (transcript at 6); *see also* Major Northeast Bank Interview, *supra* note 42 (transcript at 4) (discussing the value to a Hong Kong bank of having a letter of credit issued by its North American correspondent).

75. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 16-17) (discussing unwillingness to continue processing letters of credit issued by banks whose customers fail to waive discrepancies in a timely manner); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 13) (discussing calls from other bankers about the interview subject's willingness to confirm letters of credit issued by lesser-known foreign banks); West-Coast Bank Interview, *supra* note 26 (transcript at 9-10) (explaining that confirmation by a United States bank of a letter of credit issued by a foreign bank with which he is not familiar would assuage concerns about the reliability of the foreign bank and its customer).

monitoring of the actual trading partners.

b. Does the Bank Vouch for the Buyer? Although a seller considering a transaction in a foreign country can verify the reliability of the foreign bank more readily than it can the reliability of the foreign merchant, what significant information about the foreign merchant does the foreign bank convey when it issues the letter of credit? After all, the foreign bank does not accept any financial responsibility for the actions of its customer, the buyer (except in the indirect sense that the bank is obligated to pay when the documents in fact comply). Specifically, and perhaps more to the point, the bank does not undertake even to encourage the buyer to waive any discrepancies that might undermine the bank's obligation to pay the seller for the shipment.

By the time I finished collecting the information for the study, I became persuaded that banks effectively vouch for their customers when they issue letters of credit for them.[76] For one thing, some bankers directly stated that the bank's reputation was at risk whenever their customers refuse to waive discrepancies in presentations seeking payment on letters of credit.[77] One explained:

> [B]anks are very sensitive to their credibility. It doesn't mean they won't reject documents when documents are presented that do not conform to the letter of credit. They'll do that but they're very sensitive about having the letters of credit not paid when they are supposed to be paid.[78]

Indeed, several bankers — especially those to whom I spoke in Japan — reported that they "persuade[d]" or "pressure[d]" their customers to waive the discrepancies in any case in which the seller's performance was not *seriously* defective.[79]

Several bankers, however, insisted that they would not engage in such efforts, pointing out that their customers are entitled to insist that the bank adhere strictly to the terms of the letter of

76.*See* Foreign Bank Interview, *supra* note 56 (transcript at 5) (suggesting that issuance of a letter of credit provides a "credit reference" and agreeing that the reference extends not only to financial strength but also to general probity); Midwest Bank Interview, *supra* note 29 (transcript at 6) ("If you have an issuing bank that is of a certain reputation and class and standing it's not a difficult leap of faith to say that the customers that they're issuing letters of credits on behalf of — that . . . the customer is worthy of that extension of credit."); West-Coast Bank Interview, *supra* note 28 (transcript at 10) ("[T]hat a bank in India will issue a credit for this importer . . . says they must think highly of them.").

77. Foreign Bank Interview, *supra* note 56 (transcript at 7) ("We're very uncomfortable whenever we do refuse a set of documents. So even though I guess we're pretty willing to find discrepancies and call a customer up and say, 'These are all the discrepancies,' . . . [w]e want them to waive all those discrepancies. If they are going to refuse . . . we want it to be based on good grounds for refusal.").

78. Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 17).

79. *See* Anonymous Japanese Bank Interview, *supra* note 32 (transcript at 5) ("[W]e do not force them, but we ask them very persuasively to pay immediately."); Fuji Bank Interview, *supra* note 28 (transcript at 10) ("To suspend the payment sometimes sends a negative message for the bank."); Fuji Bank Interview, *supra* note 28 (transcript at 11) (discussing efforts to persuade customers to waive defects); Sumitomo Interview, *supra* note 34 (transcript at 8) ("[I]f there is some slight discrepancy then of course we try to persuade them to pay for the draft."). I do not mean to suggest a peculiar Japanese attitude, only that the Japanese attitude differs from the American attitude. My only possible source of direct information on the attitudes of bankers from countries other than the United States and Japan would be my work at foreign-owned banks in the United States. My impression — which might be worth little — is that the foreign-owned banks that I visited were not substantially influenced in the "culture" of their letter-of-credit departments by their foreign ownership. It is true, however, that the only American banker willing to admit to a similar practice was at an American office of a foreign bank. He explained: "We'd tell them that they're playing games and we've actually told customers to take their business elsewhere if they're going to do that. . . . So, we try to put as much pressure on them as possible and say, 'You've got to pay.'" Foreign Bank Interview, *supra* note 56 (transcript at 9).

credit.[80] But a deeper examination of the practices of those bankers suggests that even they are vouching for their customers, albeit in a subtle and indirect manner.[81] The dispositive point for me is the consistent statements of sophisticated letter-of-credit bankers that they will not issue letters of credit indiscriminately. All of the bankers with whom I discussed the topic agreed, in one way or another, that they engage in a serious screening process of customers for whom they issue letters of credit.[82] Although the customer's ability to reimburse the bank for any payments that it makes on letters that it issues on the customer's behalf is *necessary*, it plainly is not *sufficient*: the process (like much of commercial banking) involves broader questions of general commercial probity and "character."[83]

The behavior of banks backed up these statements; a bank that became convinced that a customer was acting opportunistically with respect to its trading partners would consider ceasing to issue letters of credit for that customer. More than one banker reported incidents in which the banker refused to continue dealing with major, profitable customers because of dissatisfaction with the business dealings of the customer.[84] Most importantly, several bankers acknowledged that one notable type of malfeasance that would undermine the willingness to continue a relationship would be a pattern of refusing to waive discrepancies in letter-of-credit transactions[85] that went beyond normal behavior

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80. *See* Major Midwest Bank Telephone Interview, *supra* note 42 (transcript at 8) ("We don't urge our clients to pay. That's the client's decision."); Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 14); West-Coast Bank Interview, *supra* note 26 (transcript at 3).

81. *See* Foreign Bank Interview, *supra* note 56 (transcript at 4) (describing the significance of "[t]he fact that a bank is willing to issue a letter of credit for somebody"); West-Coast Bank Interview, *supra* note 26 (transcript at 9) ("[T]he fact that a bank will issue a letter of credit tells me something about the credit standing of that customer which gives me a good feeling."). One banker agreed that many bankers make such a "quantum leap of faith," but that it is "unwarranted." He explained that point by identifying several reasons why one bank might be willing to issue a letter of credit for a weak applicant, which would not justify a second bank in relying on the applicant. Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 13-14).

82. *See*, *e.g.*, Midwest Bank Interview, *supra* note 29 (transcript at 7) ("[S]imply because somebody comes in and asks you to issue a letter of credit you're not going to do it.").

83. *See* Major Northeast Bank Interview, *supra* note 42 (transcript at 4-5) ("U.S. banks in general will not deal with clients who are disreputable, who are dishonest, whose management is not known to them, who are in and out of bankruptcy, who are acting in an unethical and dishonest manner."); *see also* Eric N. Compton, Principles of Banking 284 (1991) (discussing "the five Cs of credit," the first of which is "character of the borrower").

84. *See* Foreign Bank Interview, *supra* note 56 (transcript at 10) ("[W]e don't like doing business with people like that. We sometimes get ourselves into big arguments with the relationship managers because they want to do the business. . . . [T]hey say 'Oh, it's a great credit relationship.' And we say, 'Well, tell them to take their letters of credit somewhere else then because we just don't want to be associated with people like this.'"); West-Coast Bank Interview, *supra* note 26 (transcript at 11) ("In particular — I know that our people are very stringent on who they grant credit to because I've seen a lot of their customers leave or be asked to leave.").

85. *See* Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 7) (explaining that the letter-of-credit department would bring to the attention of a client's relationship manager any pattern of delays in waiving discrepancies on letters of credit). For a similar sentiment from Japan, see Anonymous Japanese Bank Interview, *supra* note 32 (transcript at 11) (suggesting that his bank does not experience substantial problems with failure to waive discrepancies because of the quality of companies with which his bank deals).

for the particular industry in question[86] (with the garment industry being notorious for a custom of footdragging).[87]

c. What Does the Bank's Verification Say About the Buyer? The last difficulty lies in identifying precisely what the bank implies (for it certainly states nothing expressly) about its letter of credit customers. It seems implausible that the bank offers something as imprecise as a general credit reference along the lines of "this is the kind of customer that always pays." If so, then we would expect to see an even smaller rate of nonpayment in the transactions in which buyers have graduated to documentary-collection transactions from letter-of-credit transactions.[88] But my limited data suggests precisely the opposite: a nonpayment rate of about 10% in documentary-collection transactions[89] compared to a nonpayment rate in letter of credit transactions about 100 times smaller, on the order of one tenth of one percent.

Thus, the bank must assert something tied more directly to the letter-of-credit transaction, probably a general prediction that the buyer will

86. As more than one banker emphasized, some industries (most notably the garment industry, *see infra* note 87) are characterized by lengthy delays in waiver of discrepancies on letters of credit. But that does not mean that bankers are reluctant to issue letters of credit in that industry; rather, it means that they are more tolerant of delays than they would be in other industries. Even there, however, issuers would cease to do business with an otherwise profitable customer if it began imposing pre-waiver delays that were longer than customary. *See* Major Northeast Bank Interview, *supra* note 42 (transcript at 5-6) ("If I saw a transaction that broke an industry pattern it would raise eyebrows, it would raise a red flag for me and I hope whatever bank that was involved that was handling it."); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 18-19) ("If we had an importer who was doing this [*i.e.*, refusing to waive discrepancies in a timely manner] on a regular basis and it was outside the norm then I guess that would be it.").

87. It seems to be common in the garment industry for importers to delay their acceptance of discrepant documents by lengthy periods of time on the order of a month. *See* Major Northeast Bank Interview, *supra* note 42 (transcript at 1-3); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 18) ("We have customers here who have money who I think will jerk beneficiaries around given the opportunity because it's the nature of the trade they're in. It's the nature of the rag business."); Notes from Site Visit to Bank Number 2, at 1 (August 4, 1999 — Aug. 5, 1999) [copy on file with author]; West-Coast Bank Interview, *supra* note 26 (transcript at 3). Indeed, many bankers believe that garment-industry letters of credit are designed by the American importers to be especially complex for the purpose of enhancing the likelihood of discrepancies. *See* West-Coast Bank Interview, *supra* note 26 (transcript at 8) ("Garment-type credits are . . . notorious for discrepancies because of the text of the credits going out. They're so detailed with regard to merchandise description. It just gives an opportunity for greater mistakes to be made"). To be sure, the limited willingness to accept discrepant documents is attributed in part to the greater likelihood that even slight delays in shipment or slight nonconformities of the product will have an effect on the underlying commercial transaction. For example, a fall line of clothes that arrives two months late in December is more likely to have a diminished value than a part needed to repair a broken machine that arrives after a similar delay. *See* Mid-Sized Northeast Bank Interview, *supra* note 38 (transcript at 1-2).

The delays that those importers impose on discrepant documents usually are followed by waiver of the discrepancies and full payment on the letter of credit, but there also seems to be an expectation of negotiation outside the letter-of-credit process that might result in other concessions not apparent from the bank's files. *See* West-Coast Bank Interview, *supra* note 26 (transcript at 3). Moreover, the delays that are typical for the industry appear to be taken into account in the pricing of the transactions in the first instance. *See* Major Northeast Bank Interview, *supra* note 42 (transcript at 6):

> It is not up to me to determine what kind of a deal the buyer and the seller strike and when I started in this business 28 years ago, I was horrified to learn of some of these things until I discovered that, well yes, but in the rag trade coming from this part of the world that the vendors figure it's a forty-three day delay when they are dealing with Company A. They know that and they build it into their prices.

88. *See supra* pp. 34-35 (discussing the choice businesses make between letter-of-credit transactions and documentary-collection transactions).

89. *See supra* note 53 (reporting data on that point).

perform according to industry norms in the letter-of-credit transaction.[90] That prediction — and the parties' need to get the prediction from the bank — rest on two distinct features of the issuing bank's relations with the buyer. The first is the essentially predictive point discussed above: the bank's ability based on its past interactions with the buyer to assess the buyer's general probity. The second is a leverage-related point: the bank's understanding that it can influence the buyer's behavior on the particular question at issue, the buyer's willingness to waive discrepancies. However unconstrained the buyer's legal right to reject the documents may be, the buyer will often disappoint the bank if the buyer rejects documents that include discrepancies that normally would be waived in the industry in question.[91] And if the buyer knows that the bank will be "disappointed" by the buyer's conduct, the buyer may refrain from the conduct absent dire countervailing pressures.[92] From the perspective of the seller, the ability of the bank to influence the conduct of the overseas buyer might comprise the most important aspect of the letter of credit.

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In sum, in addition to the classic explanation — that the issuer will pay in those cases in which the seller presents compliant documents — I posit a second explanation — that the issuer is confident based on past experience or its expectation of future leverage that the buyer "voluntarily" will choose to pay whether or not the documents comply. That explanation, however, doesn't carry equal weight as a general explanation for the use of letters of credit in transactions exporting goods into the United States. In inbound transactions, sellers have access to a considerable amount of apparently reliable information about the buyers in question, particularly the large retailers that were prominent in the data.

Certainly, many overseas exporters have similar concerns about the reliability of their American customers, but the explanation presented in this section does not ring nearly as true when the transaction is a purchase by Wal-Mart in the United States from a small Taiwanese clothing manufacturer for whom it is a major customer, as it does with a one-time shipment of parts from an American manufacturer to a small business in India. Accordingly, I turn now to assert a plausible explanation for those transactions.

2. Verifying the Authenticity of the Transaction

The second explanation that appeared regularly in my interviews rests on a variety of usages of letters of credit that serve indirectly to verify the authenticity of cross-border sales transactions. Because those justifications make sense only in the contexts in which the requirements appear, they

90. *See supra* notes 85-86 and accompanying text (discussing evidence suggesting that banks would stop dealing with customers that refuse to follow industry norms in waiving discrepancies in presentations on letters of credit).

91. The ready willingness to impose nonlegal sanctions on a trading partner for insisting upon something that is entirely lawful reminds me of the sanctions that Lisa Bernstein discusses for "laying down on a contract" in her discussion of the cotton industry. *See* Bernstein, *supra* note 22. I have no firm answer for the deeper question — why does the bank sanction the buyer that refuses payment in a transaction supported by a letter of credit but not in a transaction supported only by documentary-collection arrangements? — but the most likely answer seems to be a general understanding of the issuer that its reputation is on the line for presentations against its letters of credit to be honored, where its reputation is completely disengaged from the results of a documentary-collection transaction. *See supra* note 52 (reporting the relatively lackadaisical attitude of banks to nonpayment in documentary-collection transactions).

92. *See* Mann, *supra* note 62, at 2261-62 (suggesting that the same analysis is a common justification for guaranties and standby letters of credit).

are quite local. The most important justification, for example (the governmental requirements in section (a) of the following discussion), appears only in transactions that involve imports into less economically stable countries. Hence, in the sample analyzed here (limited to transactions involving the United States) it applies only to export transactions going from the United States to such a country.

As with the practice discussed in the preceding section, the letter of credit here serves as a verification institution. Specifically, the government or a trading partner uses a direct or indirect letter-of-credit requirement as a device for limiting the risk of loss from fraudulent or illegal transactions[93] by taking advantage of the superior informational position of the beneficiary's bank.

a. Governmental Requirements. The most common example is a set of governmental requirements that tend to appear in countries for which either the weakness of the local currency or concerns about money laundering justify substantial currency controls.[94] The simplest pattern involves bogus sale-of-goods transactions, a common device that wrongdoers use to transfer currency out of a country in violation of applicable governmental rules. The typical scheme uses a transaction in which a party in the currency-restricted country purports to purchase goods from a party in a strong-currency country (such as the United States or the European Union). If the price of the goods is inflated — an Indian company buys a dozen tennis balls for $1,000 — then performance of the transaction allows the Indian buyer to transmit a large amount of currency into a foreign forum, where the Indian government often has difficulty tracing the funds.[95]

Governments can use letters of credit to hinder those transactions by requiring the use of a letter-of-credit in substantial cross-border sale-of-goods transactions.[96] With such a requirement, the government obtains an indirect verification of the legitimacy of the transaction, because the local bank often would not take the risk of participating in a transaction that seemed likely to involve an illicit transfer of funds. Thus, by imposing letter-of-credit requirements, the government indirectly motivates the banks that participate in the transaction to police apparently illicit transactions.[97]

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93. One banker commenting on a draft of this paper emphasized the narrow range of the phenomenon, transactions that are themselves illegal. Banks do not undertake, for example, to investigate or verify a manufacturer's compliance with child- or prison-labor regulations.

94. *See* Midwest Bank Interview, *supra* note 29 (transcript at 1).

95. *See* Midwest Bank Interview, *supra* note 29 (transcript at 3-4) (offering that example); *see also* Foreign Bank Interview, *supra* note 56 (transcript at 2) (offering a similar example); Major Northeast Bank Interview, *supra* note 42 (transcript at 8-9) (suggesting that the parties don't even bother to ship goods in those transactions). One banker suggested that a similar transaction could be used in reverse on large sales of goods going into a currency-restricted country. The Asian seller could issue an invoice reciting an inappropriately low price; the out-country buyer could pay the invoice directly and transfer the remainder of the actual (non-invoiced) price in hard currency to an account for the benefit of the seller in a secure location. *See* Foreign Bank Interview, *supra* note 58 (transcript at 2-3) (discussing that transaction as well-known in sales of goods to mainland China).

96. *See* Midwest Bank Interview, *supra* note 29 (transcript at 1).

97. It seems clear that bank involvement — however it might be brought about — is effective in discovering fraudulent transactions. Although it is difficult to get data, one banker did tell me that his office detects three to five such transactions each week. *See* Major Northeast Bank Interview, *supra* note 42 (transcript at 7, 9).

As it happens, few countries impose such absolute requirements.[98] Still, governments do use a variety of less direct devices for protecting against such transactions, many of which lead indirectly to the use of letters of credit. For example, the government could require a letter of credit as a condition of issuing a license in advance of an actual import or export transaction.[99] Because overseas sellers might want the buyer to have an advance license to ensure the availability of hard currency to pay for the goods when they arrive, letters of credit are common in such a regime.[100]

Even less intrusively, the government might insist that all transactions involving the payment of more than a set amount of hard currency overseas must go through a bank.[101] The government then can require banks that participate in such transactions to verify a number of particular features of the transaction to prevent fraud. At that point, the marginal cost of the letter of credit (over a collection transaction) might become so small as to make it preferable in situations in which the collection transaction otherwise would be preferable.[102]

In yet another variation, least intrusive of all, the country does not insist on letters of credit even to issue the license. But insistence on a letter of credit offers the best option for the overseas trading partner to assure the availability of currency to pay for the transaction, because the local bank will not issue the letter of credit without ensuring that the applicant has obtained the appropriate licenses to allow transfer or the required currency.[103] That use of the letter of credit protects the seller against the risk that after it ships even a conscientious purchaser (and its bank) will be unable to obtain hard currency to pay the seller for the transaction. In that regime, the government gets the benefit of the letter-of-credit verification without formally insisting that the parties use the letter of credit.

b. Private Requirements. Lenders also use letters of credit in a closely analogous way to verify the authenticity of transactions brought to them by potential borrowers. The typical pattern here is in a so-called "packing" credit transaction, in which a business in a major trading city (Hong Kong, in the most

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98. *See* Midwest Bank Interview, *supra* note 29 (transcript at 1-2) (discussing such requirements in Japan after World War II and their gradual disappearance over the intervening years; citing Malawi and unspecified countries in Latin America as still requiring letters of credit for transactions in certain commodities).

99. *See* Foreign Bank Interview, *supra* note 56 (transcript at 1) (offering that scenario). Alternatively, the government might accept lower deposits for license applications when the transaction has a letter of credit. *See* Midwest Bank Interview, *supra* note 29 (transcript at 3-4).

100. *See* Foreign Bank Interview, *supra* note 56 (transcript at 1-2) (offering that explanation); Mid-Sized Northeast Bank Interview, *supra* note 40 (transcript at 4-5) (same); *see also* Foreign Bank Interview, *supra* note 56 (transcript at 3-4 (describing recent series of transactions in which the Chinese government refused to allow Chinese banks to use hard currency to honor letters of credit that they previously had issued, even in transactions for which the banks had obtained the approvals appropriate at the time of the transaction).

101. *See* Midwest Bank Interview, *supra* note 29 (transcript at 3-4) (suggesting that India imposes such a requirement for any transaction over the equivalent of five thousand dollars).

102. *See* Midwest Bank Interview, *supra* note 29 (transcript at 3-4).

103. *See* Foreign Bank Interview, *supra* note 56 (transcript at 1-2) (offering that scenario). One banker explained that in those transactions the parties waive document examination at both ends of the transaction and that he never has seen rejection of a presentation against such a credit. *See* Midwest Bank Site Visit Notes, *supra* note 26, at 3.

common example) imports goods from one foreign country that it plans immediately to export to a purchaser in a third country. If that business (the "packer") wants to borrow money to fund its acquisition of the goods, or get a letter of credit to facilitate its acquisition of the goods, the packer must convince its local (that is, local in Hong Kong) bank of the legitimacy of its export transaction.[104]

A number of bankers explained to me that the letter of credit from the bank for the American importer allows the Hong Kong bank to verify that the entire transaction is authentic.[105] Essentially, the use of the letter of credit in those transactions rests on the view of the foreign bank that it is harder to fabricate a credible letter of credit from an American bank than it is to fabricate a credible purchase order from a large American retailer.[106]

Like the transactions discussed above, those transactions reflect use by the trading-center bank of the informational advantage of the importer's bank. That bank's greater facility at understanding its customers' transactions justifies its business of issuing letters of credit in those transactions.

IV. Conclusion

The relatively small body of information that I collected cannot provide a definitive view of the letter-of-credit transaction. Nevertheless, it provides a fascinating window to the world of letters of credit. It should not surprise readers of my past work that I cannot convince myself of any single unified explanation of the use of letters of credit.[107] Thus, my main goal here is not to explain everything about why businesses use letters of credit. My goal is less ambitious, to provide information that will initiate the development of a deeper understanding of the sophisticated dynamics of the commercial letter-of-credit transaction. I hope that the data I have collected and made available here will encourage others to look more closely at the problem. ■

104. *See* Major Northeast Bank Interview, *supra* note 42 (transcript at 3-4); Midwest Bank Interview, *supra* note 29 (transcript at 9-10); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 3); *see also* Fuji Bank Interview, *supra* note 26 (transcript at 12) (describing that transaction as a "switch" transaction).

105. *See* Midwest Bank Interview, *supra* note 29 (transcript at 9-10); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 3-4).

106. *See* Midwest Bank Interview, *supra* note 29 (transcript at 10-11); Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 3-4). As one banker explained, in countries that offer interest subsidies for export transactions, the use of a letter of credit can enhance the amount of the subsidy by extending the term of the loan. Because the bank in a packing-credit transaction loans the money to the borrower/trading company at the time that the ultimate importer provides its letter of credit, the interest subsidy can begin accruing at that time. In a transaction without a letter of credit, the bank normally would not loan the money until the trading company actually had shipped the goods to the ultimate importer. *See* Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 4-5). Effectively, that use of the letter of credit transforms a very-short-term transit-financing transaction into a much more useful working-capital financing transaction. *See* Second Major Northeast Bank Telephone Interview, *supra* note 26 (transcript at 4-5).

107. *See*, *e.g.*, Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 682 (1997) (arguing that no single cause can explain the pattern of secured credit and suggesting a group of positive and negative factors that collectively can explain that pattern).