The Nuts and Bolts of Letters of Credit

NAPCO Credit Conference
February 9, 2017

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- **Enough already, let's get on with it!**

Topics for Discussion

- **Back to the Basics**
  - General definition and characteristics
  - Common types of letters of credit
  - Governing rules for letters of credit

- **Letter of Credit Checklist**
  - Standard provisions to look for in a letter of credit

Topics for Discussion

- **Standby Letters of Credit as Collateral**
  - Integration of standby L/Cs into energy trading contracts
  - Practical considerations when using standby L/Cs

Back to the Basics

General Definition

- Put simply, a letter of credit is—
  - A binding promise by one party (“*Issuer*”)
  - To pay money to a second party (“*Beneficiary*”)
  - For the account of a third party (“*Applicant*”)
  - Upon the satisfaction of conditions expressly stated in the letter of credit

When are Letters of Credit Issued?

- **In the energy trading context, if an Applicant has**:
  - ***Limited liquid collateral*** (*i.e.*, cash) it is able or willing to provide as a form of security under margining; and
  - A ***relationship established with Issuer*** that permits L/Cs to be issued to secure Applicant's payment of its trading obligations
    - Stand-alone reimbursement agreement
    - Letter of credit facility forming part of lending arrangement

Who Provides a Letter of Credit?

- **Creditworthy Issuing Bank**
  - Contractual obligation to issue the letter of credit to a Beneficiary designated by Applicant
- **Allows a less-than-creditworthy Applicant to—**
  - Provide a form of credit support (Standby L/C)
  - Provide a form of payment (Commercial L/C)
- **Key Analysis for Beneficiaries:** How creditworthy is the Issuer?

Common Types of Letters of Credit

Standby
Letter of Credit

Commercial
(Documentary)
Letter of Credit

Revocable v.
Irrevocable

Transferable v.
Non-Transferable

Common Types of Letters of Credit

Standby Letter of Credit

Commercial (Documentary) Letter of Credit

→

Revocable v. Irrevocable

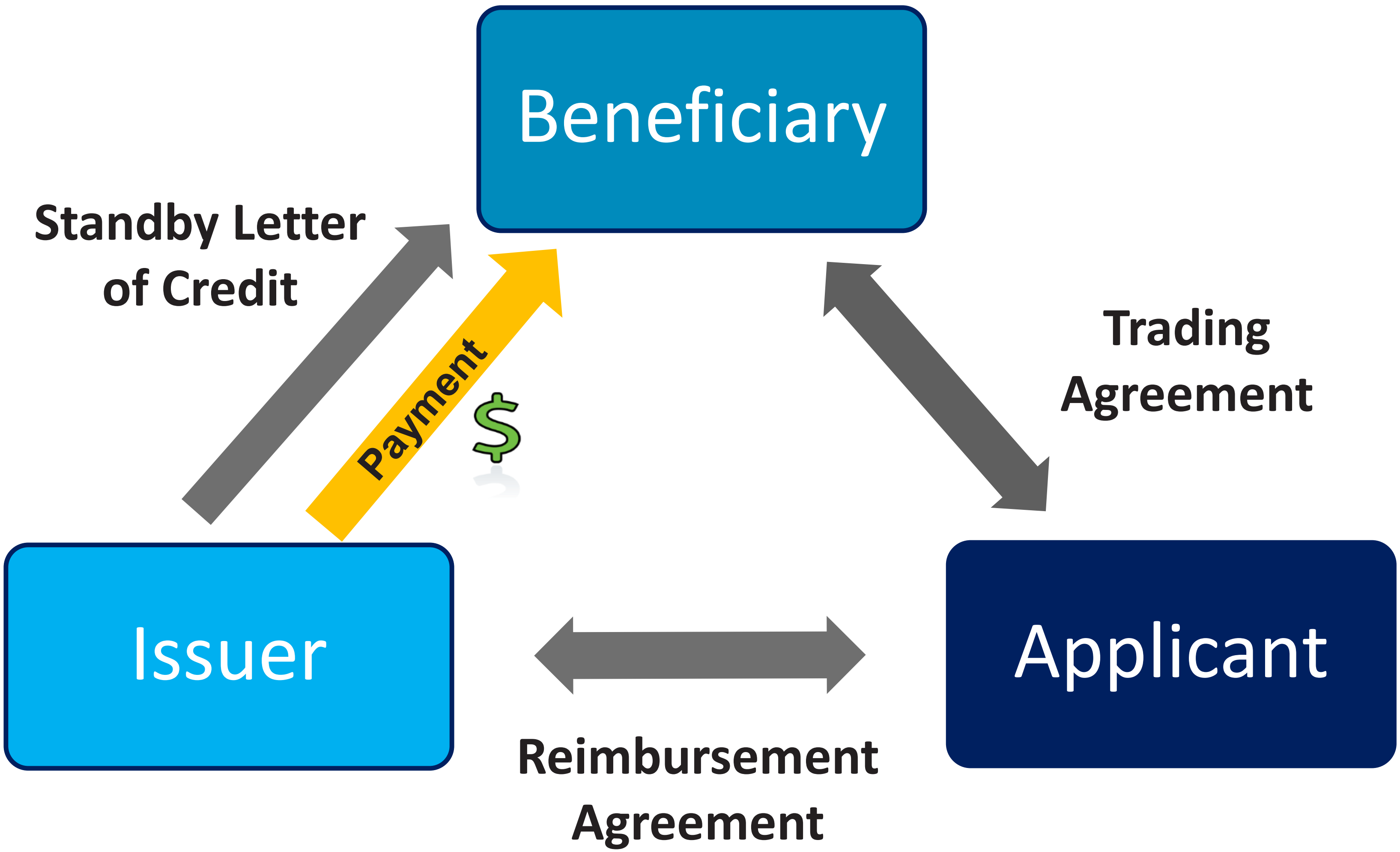
Transferable v. Non-Transferable

Standby Letter of Credit

- ***Purpose***: Instrument of ***credit support*** – not payment – to secure Applicant's obligations to Beneficiary
- ***Benefits***:
  - *Beneficiary*: Additional method of credit support
  - *Applicant*: Allows trading flexibility despite a lack of credit that might otherwise restrict commercial opportunities
- ***Typical Life Cycle***: 1 year or greater

Documents in a Standby Letter of Credit Transaction

- Trading agreement between ***Beneficiary and Applicant***
  - ISDA, NAESB, EEI, LEAP, etc.
- Letter of credit reimbursement agreement between ***Applicant and Issuer***
  - May form part of a trading company's overall lending facility and line of credit with the Issuer, or simply included in L/C application
- The letter of credit itself given by ***Issuer to Beneficiary***
  - Specific terms in the L/C dictate rights between the Issuer and Beneficiary, including how and when draws can be made


Beneficiary
Standby Letter of Credit
Payment
$
Trading Agreement
Issuer
Applicant
Reimbursement Agreement

Standby Letters of Credit
Drawing Mechanics – How to Get Paid

- Beneficiary must *strictly comply* with the terms stated in the L/C as a condition to enforcing Issuer's payment
- *Demand for Payment*
  - Certified statement that drawing condition(s) have occurred—examples:
    - Amount owed by Applicant to Beneficiary **remains unpaid**
    - Occurrence of an **event of default** in underlying trading agreement
    - The L/C is **about to expire** and the drawn funds will be used as collateral to support Applicant's future trading obligations to Beneficiary
  - Signed by authorized signatory of Beneficiary – officer, secretary, etc.

Standby Letters of Credit
Drawing Mechanics – How to Get Paid

- ***<u>Presentation of original Letter of Credit to Issuer?</u>***
  - Check L/C drawing conditions to see if required
    - General rule = **STRICT COMPLIANCE**
  - If original is lost or destroyed, may be able to obtain a replacement from Issuer if expressly permitted in the L/C
- ***<u>Method of Presentation</u>***
  - Hand delivery at physical address
  - Electronic means
  - Facsimile

So what's the difference between a standby letter of credit and a guaranty?

- Both are ***common*** forms of credit support
- Both are generally ***issued by an entity that is more creditworthy*** than the underlying trading company
  - Enhances trading company's creditworthiness
- Both require the Beneficiary to ***strictly comply with stated obligations*** in the contract before being paid
  - Ex: Demand for payment

BUT…

Standby Letter of Credit	Guaranty
• Default, in itself, is not a condition to payment • Strict compliance with document requirements (*e.g.*, a statement about the default presented in the proper format) results in payment • Issuer is primarily liable for payment • Issuer's payment is not subject to contract defenses or suretyship defenses	• Default is a condition to payment • Strict compliance with a demand for payment, in itself, is not sufficient absent a default • Guarantor is secondarily liable for Applicant's primary payment obligations • Guarantor reserves contract defenses and suretyship defenses

Common Types of Letters of Credit

Standby
Letter of Credit

Commercial
(Documentary)
Letter of Credit

Revocable v.
Irrevocable

Transferable v.
Non-Transferable

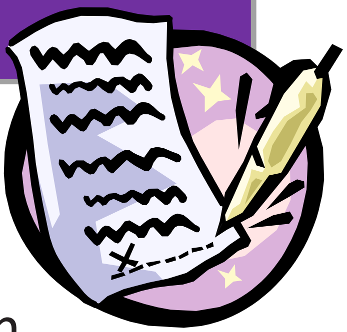
Commercial (Documentary) Letter of Credit

- ***Purpose***: Instrument of ***payment***—not credit support—drawn in the ordinary course of a transaction
- ***Benefits***:
  - Beneficiary (Seller): Assurance of payment by Issuer or Confirming Bank
  - Applicant (Buyer): Assurance that Beneficiary performs the contract in full prior to payment
- ***Typical Life Cycle***: Less than 6 months (depending on deal tenor)

Documents Involved in a Commercial Letter of Credit Transaction

- Generally the same as in a standby letter of credit transaction:
  - Trading agreement between ***Beneficiary (Seller) and Applicant (Buyer)***
  - Reimbursement agreement between ***Applicant (Buyer) and Issuer***
  - The letter of credit itself given by ***Issuer, BUT…***

Documents Involved in a Commercial Letter of Credit Transaction



- …the *L/C may be issued* ***to Beneficiary (Seller) via a Correspondent Bank***
  - Agent bank for Beneficiary (Seller) when dealing with international L/C Issuers in cross-border transactions
    - Usually located in Beneficiary's home country
    - Has existing banking relationship with the Beneficiary
  - May serve as either (or both)—
    - ***Advising Bank***: Verifies genuineness of L/C before forwarding to Beneficiary (Seller), but no obligation to make payment.
    - ***Confirming Bank***: Same general payment obligation as Issuer. If Confirming Bank pays Beneficiary (Seller), it has recourse against Issuer for reimbursement.

Commercial Letter of Credit
Drawing Mechanics – How to Get Paid

- Once Beneficiary (Seller) is satisfied with the terms of the commercial L/C, it performs under the trading agreement:
  - Ships goods or provides services
- Upon performance, Beneficiary (Seller)—
  - Prepares a ***"Draft"*** (demand for payment) according to the L/C terms:
    - *Sight Draft* – payment <u>immediately</u> upon sight
    - *Time Draft* – payment <u>within stated period of time</u> (*e.g.*, 30 days after sight)
  - Prepares and/or gathers the ***required documentation*** <u>*specified in the commercial L/C*</u>:
    - *E.g.*, invoice, certificates of quantity/quality, bill of lading, warehouse receipt

Commercial Letter of Credit
Drawing Mechanics – How to Get Paid

- Beneficiary (Seller) presents the draft and the required documentation to Correspondent Bank
  - Checks the documents for strict compliance against the commercial L/C
- If the documents strictly comply, Correspondent Bank forwards them to Issuer
  - Issuer checks the documents for strict compliance with commercial L/C
- If Issuer is satisfied that the documents strictly comply with the L/C, it pays Correspondent Bank (which forwards payment to Beneficiary) or otherwise pays Beneficiary directly
  - If Issuer fails to pay when due and the Correspondent Bank is also confirming the L/C, Beneficiary (Seller) has right to seek payment from Confirming Bank

Commercial Letter of Credit
After Issuer's Payment…The Rest of the Story

- Issuer demands reimbursement from Applicant (Buyer)
  - If Applicant (Buyer) fails to pay when due, Issuer may be able to take title and possession of the goods as a remedy if Issuer holds a bill of lading for such goods
  - ***NOTE***: For this reason, Issuer may specify in the L/C that all commercial documents—such as bills of lading for goods—be issued in a negotiable format
- Once Issuer receives reimbursement in full, it releases the commercial documents to Applicant (Buyer)
- Buyer claims the goods from the carrier by presenting the title and transport documents

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Irrevocable

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Non-Transferable

Revocable v. Irrevocable Letters of Credit

- ***Revocable***: Can be unilaterally ***amended or cancelled by Issuer without Beneficiary's consent*** at any time prior to presentation of demand for payment
  - May apply even if a drawing condition occurs, but Beneficiary has not yet presented demand
  - Must be *expressly stated* in the L/C itself
  - Only used in very limited circumstances (*e.g.*, inter-affiliate deals)

Revocable v. Irrevocable Letters of Credit

- ***Irrevocable***: Cannot be changed without the prior consent of the parties bound by the L/C
  - *UCC § 5-106(b)*: Beneficiary, Applicant, Issuer, and any Correspondent Bank
- ***Default Rule***: If the L/C is silent, the L/C is *irrevocable*
  - ISP98, UCC Revised Article 5

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Transferable v. Non-Transferable Letter of Credit

- ***Transferable***: If permitted in the L/C, Original Beneficiary can transfer its ***right to demand payment and draw*** under the L/C to a third party (the "Secondary Beneficiary")
  - "Transferable" does ***not*** necessarily mean that Original Beneficiary can assign the L/C proceeds without Issuer's consent or involvement
  - Even if transferable, the Issuer can refuse to recognize the transfer if:
    - Violates applicable law; or
    - Original Beneficiary and Secondary Beneficiary fail to comply with all transfer requirements stated in the L/C (UCC § 5-112(b))
- ***Non-Transferable***: Beneficiary *cannot* transfer its right to demand payment and draw on the L/C to a third party

Transferable v. Non-Transferable Letter of Credit

- ***Assignment of Proceeds***
  - Can apply regardless of whether L/C is transferable or non-transferable
  - Third-party assignee of proceeds has *no right to draw on the L/C*
    - Exclusively relies on the Beneficiary to present the demand and other documentation in strict compliance with the L/C's terms
    - If properly followed, Issuer pays the third-party assignee
  - Generally, *Issuer must consent* to Beneficiary's assignment of L/C proceeds to a third party assignee
    - ***BUT***—Issuer's consent *cannot be unreasonably withheld* if:
      - The assignee is actually holding the L/C; and
      - Presentation of the L/C is a condition to honoring payment
      - *See* UCC § 5-114(c)-(d)

Governing Rules & Regulations

- UCC Revised Article 5
- U.C.P.
- ISP98
- Conflicts in Regulations

UCC Article 5 (“Revised Article 5”)

- Statute applies to both commercial and standby L/Cs
- Revised in 1995 to align more closely with international practice under the U.C.P.
  - UCC Revised Article 5 codified in New York in 2000
- Not the entire body of L/C law, but addresses fundamental concepts
  - Formal requirements—*e.g.*, authenticated signature
  - Issuance, amendment, cancellation and duration terms
  - Issuer rights and obligations, including examination of documents and payment requirements
  - Warranties, fraud and forgeries

Uniform Customs and Practice for Commercial Documentary Credits ("U.C.P.")

- **U.C.P. 600**
  - Intended to govern customary practices in <u>*commercial*</u> L/Cs, but often incorporated by Issuers into <u>*standby*</u> L/Cs as well
    - Harmonized in large part with UCC Revised Article 5
  - Not statutes or regulations, but considered "standard practices" referred to in certain provisions of Revised Article 5
    - Courts often defer to the U.C.P. as an authority on L/C practices
  - In many cases, expressly adopted as the governing standard in L/Cs because of banks' familiarity with the U.C.P.

International Standby Practices 1998 (“ISP98”)

- Published in 1998, it was the first alternative to the U.C.P. for use with *standby L/Cs*
- Like the U.C.P., it’s not statutes or regulations but instead rules of accepted, customary practice
- Considered a “standard practice” and “rules of custom or practice” referenced in certain provisions of Revised Article 5
- In standby L/Cs, frequently adopted as the preferred governing standard

Conflicts in Regulations

- If you expressly state that the U.C.P. 600 or ISP98 applies to your L/C, does Revised Article 5 still apply?
- ***Yes*** – Revised Article 5 generally applies to all L/Cs
  - Statutory obligations
  - In certain cases, the statute expressly defers to "standard practices" of banks which would include U.C.P. 600 and ISP98

Conflicts in Regulations

- *BUT*...if the L/C expressly adheres to the U.C.P. or ISP98, those standards will "trump" UCC Revised Article 5 only if:
  - There is a ***direct conflict*** with Revised Article 5 terms, or
  - Revised Article 5 allows the parties to ***vary terms by agreement***
    - *E.g.*, "Unless otherwise agreed" or "unless otherwise specified" by the parties

Conflicts in Regulations

- Though generally harmonized, there are some differences between Revised Article 5, U.C.P. 600 and ISP98. ***Examples***—
  - **Expiration of L/C during Issuer Force Majeure**
    - *U.C.P. 600 Article 36 v. ISP98 Rule 3.14*
  - **Transferable L/Cs**
    - *Single v. Multiple transfers and Partial transfers*
    - *U.C.P. 600 Article 38.d v. ISP98 Rule 6*
  - **Time permitted for Issuer's examination of documents**
    - Reasonable time, not to exceed 7 business days – UCC § 5-108(b)
    - 5 banking days – U.C.P. 600 Article 14.b
    - 3 business days – ISP98 Rule 2.01(c)

Governing Rules & Regulations

- ***<u>Practical Take-Away Points</u>***:
  - UCC Revised Article 5 generally applies to all L/Cs
  - If the U.C.P. or ISP98 are expressly incorporated into an L/C (which is common), they also will apply
  - In a conflict, U.C.P. and ISP98 control over Revised Article 5 if:
    - Direct conflict
    - The UCC allows the parties to modify the UCC provision by agreement
  - L/C regulations are not uniform across the board
  - Understand the rules and adapt depending on the type of L/C involved and the nature of the underlying transaction

Letter of Credit Checklist

Letter of Credit Checklist – What to Look For

- *General Format*:
  - May be issued in any format that is a "record" (UCC § 5.104), anticipating written or electronic issuances
  - Issues specific to electronic formats:
    - Commonly used by banks to issue, amend, authenticate and make payments under L/Cs
    - Even if no physical signature, electronic L/C must be authenticated in a method agreed upon by the parties or in accordance with "standard practice" (*e.g.*, U.C.P. and ISP98 rules)
  - For efficiency and to avoid ambiguity, pre-printed L/C forms are often used and attached to trading agreements
    - *E.g.*, attach L/C form to ISDA Credit Support Annex

Letter of Credit Checklist – What to Look For

- *<u>Standby v. Commercial L/C</u>:*
  - Not necessary to label an L/C as either “Standby” or “Commercial”—this distinction is based on function
  - However, many pre-printed forms include this designation in the title or recital paragraphs
  - Keep in mind the nature of your transaction and the purpose of the L/C:
    - Credit Support = Standby L/C
    - Method of Payment = Commercial L/C

Letter of Credit Checklist – What to Look For

- *Revocable v. Irrevocable*:
  - L/C should expressly state whether it is revocable or irrevocable to avoid any ambiguity
  - General presumption is that L/Cs are irrevocable *unless* express language to the contrary:
    - UCC § 5-106(a): L/C is *revocable* only if it so provides
    - U.C.P. 600 Article 3: L/C is *irrevocable* "even if there is no indication to that effect"
  - Practically, Beneficiaries prefer that the L/C be irrevocable to avoid unilateral changes without Beneficiary's consent

Letter of Credit Checklist – What to Look For

- *Parties*: Issuer's L/C form should identify—
  - Applicant
  - Beneficiary
  - Any Correspondent Bank (Advising or Confirming Bank)
    - Details on Advising Bank authenticating the genuineness of the L/C and notifying Beneficiary
    - Details on Confirming Bank being responsible for payment
  - Any other person or agent designated to pay, accept or negotiate drafts under the L/C (a "Nominated Person")
    - *E.g.*, Issuing bank's agent who receives demands / required documentation and analyzes for compliance

Letter of Credit Checklist – What to Look For

- *<u>Amount of the L/C</u>*:
  - **Fixed Amount**:
    - Used when only a single drawdown is permitted
    - If applicable, generally with commercial L/Cs
    - *E.g.*, Single shipment of goods resulting in a single payment to Beneficiary (Seller)
  - **Maximum Amount**:
    - Used if the amount of the L/C may be reduced or will fluctuate over time, or when partial drawings are permitted
    - Common with both commercial and standby L/Cs
  - ***<u>NOTE</u>***: In negotiating the L/C amount, consider the type of deal, the term, and the overall payment/credit exposure involved

Letter of Credit Checklist – What to Look For

"We, ***Really Big Bank N.A. ("Issuer")***, hereby issue this ***irrevocable Standby*** Letter of Credit, with reference number 01-1234 ("Standby Letter of Credit"), in favor of ***ABC Trading, LLC ("Beneficiary")***, at the request and for the account of ***XYZ TradeCorp Inc. ("Applicant")***, in the ***maximum aggregate amount of $2,000,000***."

Letter of Credit Checklist – What to Look For

- *<u>Form of Draft / Demand for Payment:</u>*
  - To avoid ambiguity, the form of the draft (commercial) or demand for payment (standby) should be attached
  - Not required, but promotes administrative efficiency
  - Ensures strict compliance with drawing conditions and documentation is not a hurdle to payment

Letter of Credit Checklist – What to Look For

- *Carefully Review the Draft / Demand*:
  - *Scope*:
    - Single agreement or multiple trading agreements?
  - *Drawing Conditions:*
    - **Commercial L/C**: Generally, presentation of enumerated Additional Drawing Documents evidencing that Seller has performed
    - **Standby L/C**: What are the triggers?
      - Expressly stated defaults (*e.g.*, failure to pay)?
      - Any event of default under the agreement?
      - If the L/C expires within a certain number of days?

Letter of Credit Checklist – What to Look For

- *__Additional Drawing Documents:__*
  - Expressly stated in the Draft / Demand or in the L/C itself
  - **Commercial L/Cs**:
    - *Commercial*: invoices, packing or weight lists
    - *Shipping*: bills of lading, insurance documents, customs invoices
    - *Official Documents*: certificates of origin, inspection certificates, legalization documents
  - **Standby L/Cs**:
    - Generally none, other than the Demand for Payment

Letter of Credit Checklist – What to Look For

- *Additional Drawing Documents:*
  - **Original L/C required or is a copy sufficient?**
    - Issuer may require original L/C as a means of fraud prevention
  - **If an Original L/C is required, what about a replacement?**
    - Often permitted if the original is “lost, stolen, destroyed or mutilated”
    - May require Beneficiary to either return the mutilated L/C to Issuer or provide a certified statement that the L/C was lost, stolen or destroyed
    - In some cases, Issuer may require Beneficiary to indemnify against fraud
  - **Practical Take-Away: Stuff Happens**
    - If an Original L/C is required, Beneficiary should ensure the L/C allows for some type of replacement mechanism

Letter of Credit Checklist – What to Look For

- *<u>Presentation</u>: Make sure the L/C includes—*
  - ***How*?**
    - Physical delivery to the Issuer? Mail or courier? Facsimile or other electronic means?
    - Effective "upon receipt" or "upon transmission" of documents?
  - ***Where*?**
    - Only at the primary branch or is a satellite branch acceptable?
    - Confirm that address information is included
  - ***When*?**
    - Banking day by a specific time (*e.g.*, close of business / 12:00 p.m. EST)?
    - Any time on or before the expiration date of the L/C?

Letter of Credit Checklist – What to Look For

"We undertake to the Beneficiary to honor the Beneficiary's demand for payment of an amount available under this Standby Letter of Credit, ***upon Beneficiary's presentation of a demand for payment, effective on our receipt,*** in the ***form attached as Exhibit A*** hereto, ***together with the original*** of this Standby Letter of Credit, at the ***counters of the Issuer located at 1000 Main Street, Houston TX, 77002***, on or before the ***close of business on the Expiration Date*** (defined below)."

Letter of Credit Checklist – What to Look For

"At the ***request of the Beneficiary*** prior to the expiration date of this Standby Letter of Credit, we will issue a ***replacement standby letter of credit*** to the Beneficiary, on the same terms as the Standby Letter of Credit (including any amendments), ***if*** the Beneficiary either ***returns the mutilated Standby Letter of Credit*** to us, ***or certifies to us in writing that the Standby Letter of Credit has been lost, stolen or destroyed*** and ***provides us with an indemnity*** reasonably satisfactory to us in connection with such certification."

Letter of Credit Checklist – What to Look For

- *Expiration Date:*
  - Confirm that the L/C expressly states the date on which Beneficiary's rights and Issuer's obligations terminate
  - Under ISP98 (Rule 9.01), an L/C must either—
    - State an expiration date; or
    - Allow the Issuer to terminate the L/C (i) by giving reasonable prior notice to the Beneficiary, or (ii) upon payment.
  - If the L/C doesn't state a definite expiration date, then—
    - Expires 1 year after issuance (UCC § 5-106(c))
    - If "perpetual", expires 5 years after issuance (UCC § 5-106(d))

Letter of Credit Checklist – What to Look For

- *Expiration Date:*
  - Confirm that the Expiration Date falls on a banking or business day
    - U.C.P. 600 Article 29: Extends expiration date if the Issuer is closed on such date for reasons other than Force Majeure
    - However—best practice is to clarify this point in the L/C itself
  - **Standby L/Cs**: Usually a 1-year term
  - **Commercial L/Cs**: Shorter duration because L/C generally terminates upon payment to Seller for performance
    - *Exception*: Installment contract may require L/C with a longer tenor

Letter of Credit Checklist – What to Look For

- *<u>Expiration Date – Evergreen Clauses</u>*
  - Automatic extension of the L/C's term without the Issuer or Beneficiary taking any further action
    - ***<u>NOTE</u>***: In many cases, however, Issuer can provide notice to Beneficiary before the initial term expires if Issuer does not want to extend the L/C
  - *<u>Final Maturity Date</u>*: Even if the L/C contains an evergreen clause, it usually includes a specific date after which the L/C will no longer be extended

Letter of Credit Checklist – What to Look For

- *<u>Expiration Date – Extension by Amendment</u>*
  - If the L/C does *<u>not</u>* contain an evergreen clause and the parties want to extend the expiration date, an amendment is required
  - How to amend the L/C depends on whether it is revocable or irrevocable
    - Issuer's unilateral action, or additional consent by Beneficiary/Applicant
    - In most cases, both Issuer and Beneficiary are in agreement to extend the term. Under the U.C.P., Applicant's consent is not required.
  - Generally, consent to an amendment does not have to be in writing unless the L/C requires it
    - *See* U.C.P. 600 Article 10.c

Letter of Credit Checklist – What to Look For

"***The expiration date of this Standby Letter of Credit is September 29, 2014 (or, if such date is not a banking day, the immediately-following banking day)*** ("Expiration Date"); provided, however, the Expiration Date shall be ***automatically extended for successive one-year periods, unless we elect*** in our sole and absolute discretion ***not to extend*** the then-current Expiration Date ***and notice*** of such election is ***sent*** to the Beneficiary's address ***no less than 30 days prior*** to the then-current Expiration Date. ***In no event will the Expiration Date be subject to automatic extensions beyond September 29, 2017 (or, if such date is not a banking day, the immediately-following banking day)***."

Letter of Credit Checklist – What to Look For

- *<u>Payment Terms:</u>*
  - Timing for Issuer to pay Beneficiary after presentment of required documentation
  - Issuer needs time to examine the Draft / Demand and Additional Drawing Documents to ensure strict compliance
    - <u>ISP98 Rule 201(c)</u>: **3 business days**
      - For Standby L/Cs, not as much time needed because usually just examining a Demand for Payment
    - <u>U.C.P. 600 Article 14.b</u>: **5 banking days**
    - <u>UCC § 5-108(b)</u>: Reasonable time, not to exceed **7 business days**
  - *<u>Method of payment</u>*: wire transfer, check, etc.

Letter of Credit Checklist – What to Look For

"We undertake to make payment to Beneficiary under this Standby Letter of Credit ***within three (3) business days of receipt*** by us of a ***properly presented Demand for Payment***. The Beneficiary shall receive payment from us by ***wire transfer*** to the ***bank account*** of the Beneficiary ***designated in the Demand for Payment***."

Letter of Credit Checklist – What to Look For

- *<u>Partial and Multiple Drawings:</u>*
  - **Standby L/Cs**: Partial drawings may be permitted because of the L/C's function as credit support
    - Credit risks and exposure shift throughout the life of a deal
    - If a default occurs and Beneficiary can draw, the amount owed to Beneficiary probably will not equal the maximum aggregate amount of the L/C
  - ***<u>BUT NOTE</u>***: Some standby L/Cs permit Beneficiary to draw down the "entire undrawn portion" of the L/C
    - In this case, partial/multiple drawings may not be needed
    - Check your drawing conditions and trading contract rights

Letter of Credit Checklist – What to Look For

- *<u>Partial and Multiple Drawings:</u>*
  - **Commercial L/Cs**: May apply depending on settlement mechanics and the term of the deal
    - *Installment contracts* – *e.g.*, "Seller agrees to deliver 1,000 bbls of crude to Buyer each month during a 1-year term. Upon performance each month, Seller is due payment for the product delivered in such month."
    - For convenience, the commercial L/C may be issued in an amount up to the value of the entire contract
    - Seller makes multiple, partial drawings each month after shipment
  - **Reduction in Aggregate Amount:** Any partial drawings will reduce the amount available under the L/C

Letter of Credit Checklist – What to Look For

"***Partial and multiple drawings are permitted*** under this Standby Letter of Credit. The aggregate amount available under this Standby Letter of Credit at any time shall be the ***face amount*** of this Standby Letter of Credit, ***less the aggregate amount of all partial drawings previously paid to Beneficiary at such time***."

Letter of Credit Checklist – What to Look For

- *Choice of Law and Regulations:*
  - **New York law**:
    - Most common choice of law for standby L/Cs
    - Generally involving U.S. Issuers and/or U.S.-based transactions
    - If elected, incorporates UCC Revised Article 5
  - **English law**:
    - Common choice of law for cross-border transactions, particularly involving marine shipments
    - Elected in commercial L/Cs more often than in standby L/Cs
  - **Other regulations**:
    - ISP98 and/or U.C.P. 500/600?

Letter of Credit Checklist – What to Look For

"This Standby Letter of Credit is subject to the laws of the ***State of New York*** and the [***International Standby Practices 1998 (ISP98), International Chamber of Commerce Publication No. 590***][***Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No. 600***]."

Standby Letters of Credit as Collateral

Adequate Assurance of Performance

ISDA Schedule (if added)	NAESB § 10.1	EEI § 8.1/8.2(b) (if elected)

- Required upon demand by a party that has "reasonable grounds for insecurity" regarding performance
- Accepted form of assurance may include a letter of credit
  - Because it's credit support, most likely standby and irrevocable
- Caps on the Performance Assurance amount may directly impact the amount of the L/C:
  - Any amount "reasonably acceptable" to the Secured Party?
  - Limited to then-current exposure of the Secured Party?
- Confirm any limitations on the L/C amount and Issuer

MAC Clause / Downgrade Event

ISDA Schedule (if added)	NAESB (if added)	EEI § 8.1/8.2(d) (if elected)

- If a party or its guarantor experiences a “material adverse change” or a “downgrade event”, often based on a credit ratings trigger, then Performance Assurance is required
- Performance Assurance may include a letter of credit
  - Standby, irrevocable L/C is typical in energy trading contracts
- Confirm any limitations on the L/C amount and Issuer

Margining Arrangements

ISDA CSA | NAESB CSA | EEI CA or § 8.1/8/2(c)

- In most energy trading agreements, standby letters of credit are contemplated as a form of collateral that can be used for margining purposes
  - **ISDA CSA**: "Other Eligible Support" in Paragraph 13
  - **NAESB CSA and EEI CA**: "Eligible Collateral" election in Cover Sheet
  - **EEI § 8.1/8.2(c)**: In the definition of "Performance Assurance"

Practical Considerations When Using Letters of Credit as Collateral

- Issuer Requirements
- Timing for Issuance or Amendment
- Valuation & Letter of Credit Defaults
- Additional Letter of Credit Terms

Issuer Requirements: Does Your L/C Issuer Qualify?

- Most trading agreements will impose some limitations on the Issuer providing the L/C
  - Minimum rating requirements
    - *E.g.*, "A-" by S&P and "A3" by Moody's
  - Asset and/or net worth threshold
    - *E.g.*, $10 billion in assets
  - Jurisdiction of the Issuer
    - *E.g.*, U.S. commercial bank or a U.S. branch of a foreign bank
- *May show up in various places*:
  - "Qualified Institution" = added to ISDA CSA Paragraph 13 definitions
  - "Letter of Credit Issuer Requirements" = NAESB CSA cover sheet
  - "Letter of Credit" = EEI CA definitions

Timing for Issuance or Amendment

- The timing required for “transfers” of letters of credit under margining arrangements can be a significant issue
- For L/Cs, a “transfer” usually means delivery to the Secured Party, or return to the Pledgor, of either:
  - The *original* L/C; or
  - An *amendment* to the L/C
- ***Key Question for Pledgors/Applicants***: How does the timing under your trading contract line up with timing requirements under your L/C facility?

Timing for Issuance or Amendment

- *General timing requirements*:
  - **ISDA CSA and EEI CA**:
    - If demand received *on or before* Notification Time: L/C must be delivered by close of business on the ***next-following business day***
    - If demand received *after* the Notification Time: L/C must be delivered by close of business on the ***second-following business day***
  - **NAESB CSA:**
    - Close of business on ***business day after the demand***

Timing for Issuance or Amendment

- *This may be fine for cash, but what about L/Cs*?
  - Depending on when you receive the demand, you may only have a little over 1 business day to cause issuance or amendment
  - For many facilities and Issuers, this will be too tight of a timeframe and may result in a breach
- ***Solution?***
  - Check your L/C facility to determine Issuer obligations
  - If necessary, increase the time permitted for Pledgor to transfer L/Cs to the Secured Party
    - *E.g.*, 2 or 3 business days after the demand

Valuation & Letter of Credit Defaults

- ***Value*** = Undrawn portion of the L/C multiplied by the "Valuation Percentage"
  - ISDA CSA, EEI CA, NAESB CSA
- Generally, the "Valuation Percentage" equals 100% *unless*:
  - A "Letter of Credit Default" has occurred; or
  - 20 or fewer days remain before expiration of the L/C
- ***Result***: If the Value of the L/C is zero, Pledgor must provide alternate form of credit support to avoid breach

Valuation & Letter of Credit Defaults

- ***<u>Letter of Credit Default—Examples:</u>***
  - Issuer fails to meet stated eligibility requirements
  - Issuer goes bankrupt
  - Issuer fails to comply with obligations under the L/C
  - Issuer disaffirms, disclaims, repudiates or rejects the L/C
  - L/C expires or terminates (other than according to its terms) before Pledgor's obligations are satisfied in full
- ***<u>NOTE</u>***: L/C Default (collateral trigger) is different than an Event of Default (termination right)

Additional Letter of Credit Terms

- Timing for Issuer to renew an existing L/C or Pledgor to provide a substitute L/C or other credit support
- "Transfer" includes providing an amendment to an existing L/C (*e.g.*, increasing maximum amount, etc.)
- If Pledgor is a Defaulting Party, then Secured Party can draw on the entire undrawn portion of the L/C
  - Cash received is deemed "Posted Collateral"
  - Pledgor remains liable for any unpaid amounts owed to Secured Party
- ***NOTE***: Confirm the terms of the L/C (particularly drawing conditions) line up with L/C terms in the trading contract

Questions?

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