The Nuts and Bolts of Letters of Credit

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The following presentation is a general overview of letter of credit basics and their utilization in energy trading agreements.

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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
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
**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

Issuer

Applicant

Standby Letter of Credit

Trading Agreement

Reimbursement Agreement

Payment
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.
• **Presentation of original Letter of Credit to Issuer?**
  
  • 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

• **Method of Presentation**
  
  • Hand delivery at physical address
  
  • Electronic means
  
  • Facsimile
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**
- 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

**Guaranty**
- 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...
...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.
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 immediately upon sight
  - *Time Draft* – payment within stated period of time (e.g., 30 days after sight)

- Prepares and/or gathers the *required documentation specified in the commercial L/C*:
  - *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
Common Types of Letters of Credit

- Standby Letter of Credit
- Commercial (Documentary) Letter of Credit

Revocable v. Irrevocable
Transferable v. 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
Common Types of Letters of Credit

- Standby Letter of Credit
- Commercial (Documentary) Letter of Credit

Revocable v. Irrevocable
Transferable v. Non-Transferable
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)
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 *commercial* L/Cs, but often incorporated by Issuers into *standby* 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)
**Practical Take-Away Points:**

- 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
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

- **Standby v. Commercial L/C:**
  - 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
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

- **Amount of the L/C:**
  - **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

- **NOTE:** In negotiating the L/C amount, consider the type of deal, the term, and the overall payment/credit exposure involved
“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."**
Form of Draft / Demand for Payment:

- 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
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
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
**Presentation:** 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?
“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).”
“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.”
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))
**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
Expiration Date – Evergreen Clauses

- Automatic extension of the L/C’s term without the Issuer or Beneficiary taking any further action

  - **NOTE**: 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

- **Final Maturity Date**: 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
Expiration Date – Extension by Amendment

- If the L/C does not 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
“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

- **Payment Terms:**
  - 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
    - ISP98 Rule 201(c): **3 business days**
    - For Standby L/Cs, not as much time needed because usually just examining a Demand for Payment
    - U.C.P. 600 Article 14.b: **5 banking days**
    - UCC § 5-108(b): Reasonable time, not to exceed **7 business days**
  - **Method of payment:** wire transfer, check, etc.
“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.”
Partial and Multiple Drawings:

- **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

- **BUT NOTE**: 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
Partial and Multiple Drawings:

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
“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.”
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?
“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
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
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
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
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*
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
**Letter of Credit Default—Examples:**

- 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

**NOTE:** 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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