Understanding Letters of Credit in Nigeria: How it Works

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1. Introduction

A Letter of Credit ("**LoC**") is a trade finance tool that ensures a seller gets paid for goods, and the buyer gets the goods paid for. It is a contractual commitment by a foreign buyer's (importer's) bank that payment will be made to a beneficiary (exporter), provided that the terms and conditions stated in the letter of credit have been met as evidenced by the presentation of specified documents. See *Conoil v. Vitol. S. A.*[1] A guiding principle of an LoC is that the issuing bank will make payment based solely on the documents presented, and the issuing bank is not required to physically ensure the shipping of the goods or the genuineness of the documents presented.[2] If the documents presented are in accord with the terms and conditions of the LoC, the bank has no reason to deny the payment. More so, where the bank complies strictly with the buyer's instructions in making payment, the bank is entitled to the indemnity of an agent.[3]

- **Importance of Letter of Credit in International Trade**

Trading globally involves a lot of unique factors and risks — that are not seen in domestic trade. Countries have different laws; it can take weeks for goods to be shipped; there is the risk of non-payment or non-delivery; and parties often do not know each other personally. Thus, the use of LoCs has become a very important aspect of international trade to protect buyers and sellers. On the part of the seller, LoCs guarantee payment upon fulfillment of the stipulated contractual conditions thereby mitigating the risk of non-payment, while on the buyer's part, it ensures that money is not released until the goods have been shipped or delivered.

2. Who are the parties involved?

At its simplest, an LoC involves three main parties: the Applicant (Buyer), the Beneficiary (Seller), and the Issuing Bank (Buyer's Bank). However, the process can often involve additional parties to increase security and/or manage risks.

The Parties in LoC transactions include:

- **Buyer (Applicant/Importer)**: the party who requests his bank to issue a letter of credit.
- **Seller (Beneficiary/Exporter)**: the party who receives his payment upon fulfilment of the terms and conditions of the transaction.
- **Issuing Bank**: Also called an opening bank[4] is responsible for opening and issuing the LoC at the buyer's request. It may specify a reimbursing bank where payments will be made.

Additional Parties may include:

- **Advising Bank:** Usually located at the Seller's country, is the bank that advises the Seller that the LoC has been issued upon receipt from the Issuing bank. The advising bank may also verify the authenticity of the LoC but are not responsible for making payment. The Advising Bank could be a branch office of the Issuing Bank or a correspondent bank, or a bank appointed by the beneficiary.
- **Confirming Bank**: This bank provides an additional guarantee to the Issuing bank. This comes in, where the beneficiary seeks additional assurance of payment.
- **Negotiating Bank**: This bank could be a separate bank or an advising bank.[5] It is responsible for negotiating the documents related to the LoC submitted by the Seller. That is, it receives and examines the seller's documents to ensure they adhere to the terms and conditions specified in

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[1] (2018) 9 NWLR (Pt. 1625) 463.

[2] See *Nasaralai Enterprises Ltd v. Arab Nank (Nig) Ltd* (1986) LPELR-1942(SC) where the Supreme Court held that *"[t]he bank is under no duty to take any further steps to investigate the genuineness of a signature which, on the face of it, purports to be the signature of the person named or described in the letter of credit."* The Apex Court further held that the duty of the issuing bank is to examine documents with **reasonable care** to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit.

[3] *UBN Ltd. v. Osezuah* (1997) 2 NWLR (Pt. 485) 28, P.40G-H.

[4] Muskan S, "Letter of Credit (LC): Parties, Types and Documents" accessed at https://www.yourarticlelibrary.com/banking/letter-of-credit/letter-of-credit-lc-parties-types-and-documents-banking/99061

[5] Ibid.

the LoC. It makes payments to the Seller, subject to the completeness of the documents and claims reimbursement under the credit.[6] So, it may either immediately credit or pay the seller/exporter based on the LoC terms, or, alternatively, it may pay the exporter once it has received funds from the issuing bank.

- **Reimbursing Bank**: This bank is responsible for making payments to the negotiating bank upon receipt of the necessary documents and verification that the conditions in the LoC have been fulfilled. This could be the correspondent bank of the issuing bank.

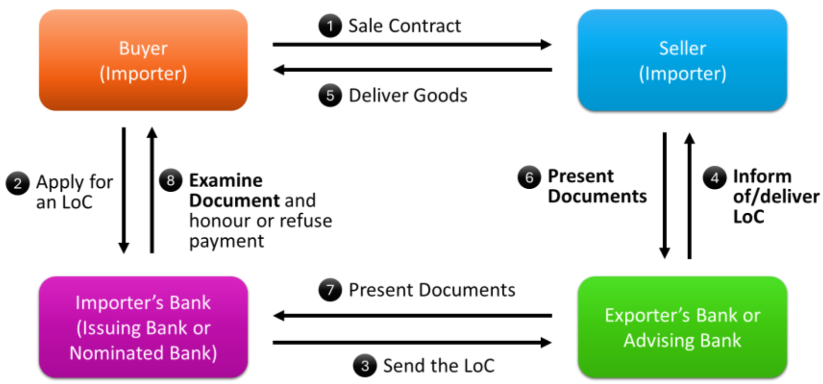
3. How does a Letter of Credit work?

Usually, the seller demands an LOC while entering a sales contract. The buyer upon agreement on the terms of the sales contract, applies to a financial institution usually a bank to issue an LoC in favour of the Seller by submitting a written application and relevant documents. The issuing bank evaluates the buyer's creditworthiness and issues the LoC.[7]

The issuing bank sends the LoC to the advising bank which upon verification of its authenticity and approval of the terms therein, informs the Seller that the LoC has been issued. Along with the LoC, the Seller furnishes various documents like an airway/shipping bill, packing list, commercial invoice, insurance certificate, certificate of origin, certificate of inspection, and lading bill as proof of the fulfilment of the LoC stipulated conditions.[8] The issuing bank makes payment to the Seller or the negotiating bank upon fulfilment of the requisite conditions and obligations.[9]

It bares noting that, once an LoC has been issued and confirmed, the issuing bank has an absolute obligation to pay the Seller if the documents are in order and the terms of the credit are satisfied, irrespective of any dispute there may be between the seller and the buyer as to whether the goods are up to the underlying contract or not. Any such dispute between buyer and seller must be settled between themselves. See *Nasaralai Enterprises Ltd v. Arab Nank (Nig) Ltd*. [10]

Below is a graphical representation of this process;



- **Any difference between Letters of Credit and Bank Guarantees?**

LoCs and Bank Guarantees are both financial instruments in trade financing used as evidence of creditworthiness, risk mitigator, and peculiar to where parties do not have an established business

[6] Siddhi Parekh, "Letter of Credit (LC) - Meaning, Process & Role In International Trade" (August 31, 2022) accessed at https://www.dripcapital.com/resources/blog/letter-of-credit-lc

[7] Banks usually impose a certain fee (usually a specific percentage of the LoC amount which may vary by bank and/or the size of the LoC) for extending these services.

[8] All LoCs must stipulate an expiry date for presentation of documents for payments, acceptance or negotiation, notwithstanding the stipulation of a latest date for shipment. See *Akinsanya v UBA Ltd* (1986) LPELR-355(SC)

[9] *Supra*. The bank can reject documents which do not comply with the terms and conditions of the letter of credit. See *Nasaralai Enterprises Ltd v. Arab Nank (Nig) Ltd.* (1986) LPELR-1942(SC) Pp 26 - 26 Paras A - D.

[10] (1986) LPELR-1942(SC) Pp 23 - 23 Paras A – E. It is also worthy to note that the bank's obligation to honour the credit remains even if the bank has knowledge that the seller has allegedly committed a breach of the underlying contract with the buyer, which would have ordinarily allowed the buyer to rescind the contract, reject the goods, and refuse payment. This would not prevent the bank from honouring its obligation to pay, provided the documents provided comply with the requirements of the LoC. See *The Export-Import Bank of the USA v. NDIC* (2021) LPELR-53399(CA) Pp 20 - 24 Paras F – D.

relationship.[11] Despite these features, LoCs and Bank Guarantees have distinctive features and serve different purposes.

LoCs are especially indispensable in international trade due to the difference in trade laws and the existence of impersonal relationship between parties. While bank guarantees can be utilised in both domestic and international trade but are often used in real estate contracts and infrastructure projects.[12]

Under LoCs, banks undertake greater liability to ensure payment upon fulfilment of conditions specified without necessarily waiting for the buyer's default. In contrast, for bank guarantees, the bank is only required to step in when the buyer defaults on payment.[13]

LoCs primarily address payment risks in international trade, while bank guarantee on the other hand addresses both performance or contractual defaults which could be in terms of goods or services delivery (i.e. performance-based guarantee), or payment (i.e. finance-based guarantee) or other contractual obligations.

Parties under Bank guarantees consist of three (3)- both parties involved in the contract and the financial institution. On the other hand, parties in an LoC may consist of more than three (3) depending on the structure of the transaction.

4. Types of Letters of Credit

LoCs can vary widely based on factors not limited to, the purpose of the transaction, specific requirements of the parties, payment terms, creditworthiness of the parties, regulatory considerations, industry-specific needs, and whether the LoC is revocable or irrevocable. As a result, there are several types of LoCs, each suited to different business needs and transaction structures, including commercial LoCs, standby LoCs, revolving LoCs, and transferable LoCs, among others.

- **Commercial LoCs:** one of the commonest form of LoCs, also called a documentary credit. In this form of LoC, the issuing bank makes payment directly to the seller as the beneficiary upon the fulfilment of the specified conditions.

- **Revolving LoCs:** Under this LoC, the issuing bank allows a customer (the buyer) make multiple number of draws up to a set limit over a specified period of time. They are most ideal for ongoing trade arrangement between an importer and exporter (e.g., regular shipments over a specified period). This LoC eliminates the need for multiple LoCs for each transaction and minimises amendments.

- **Transferable or non-transferable LoCs:** A transferable LoC can, with the seller's consent, be transferred in whole or part to a second beneficiary. They are commonly used when intermediaries are involved in a transaction. For example, when the beneficiary is a middleman who needs to pay suppliers. Usually, the transferee cannot transfer it further to another beneficiary, unless the LoC expressly provides otherwise.[14] Under a non-transferable LoC, the Seller cannot transfer the credit to a third party and it is not convenient in transactions involving an intermediary.

- **Revocable or Irrevocable LoCs:** A revocable LoC can be altered or cancelled by the issuing bank without prior notice to the beneficiary. On the other hand, an irrevocable LoC cannot be altered or cancelled without the consent of the parties involved. An irrevocable LoC provides more security to a seller as the terms cannot be changed unilaterally unlike revocable LoCs.

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[11] Key Differences, Difference Between Letter of Credit and Bank Guarantee accessed at https://keydifferences.com/difference-between-letter-of-credit-and-bank-guarantee.html
[12] Ibid
[13] Ibid. Except where the LoC is a standby LoC (SBLC). See standby LoC (SBLC) discussed below.
[14] WallStreetMojo Team, "Letter of Credit" (November 10, 2021) accessed at https://www.wallstreetmojo.com/letter-of-credit-lc/

On circumstances when a letter of credit may be revoked, the Court of Appeal has held that it can be cancelled at the stage of processing. However, it cannot be cancelled when the credit has been issued and forwarded to the confirming bank. Hence, it is advised that an importer that seeks to cancel a letter of credit should do so before it is issued and forwarded to the confirming bank.[15] In *Akinsanya v UBA Ltd*.[16], the Supreme Court held that where a buyer or the issuing bank has cause to challenge the compliance with the conditions of the letter of credit and therefore desires to repudiate the contract, then he must act quickly.[17]

Other instances where LoCs can be cancelled or revoked includes where the LoC is a Revocable LoC, which can be cancelled or amended at any time by the issuing bank or the buyer without the seller's consent, provided that the beneficiary has not yet presented the required documents for payment.

- **Confirmed or Unconfirmed LoCs:** In a confirmed LoC, a second bank (confirming bank) adds its guarantee to the LoC issued by the original bank (issuing bank), ensuring payment will be made. This is used where the seller is concerned about the issuing bank's creditworthiness or political and/or economic risk associated with the buyer's country. An unconfirmed LoC is an LoC that has not been guaranteed or confirmed by any bank other than the issuing bank.

- **Back-to-Back LoCs:** This LoC is commonly used in complex trade transactions involving intermediaries and a transferrable LOC is unsuitable. Two LoCs are issued- one by the buyer's bank to the intermediary and the second by the Intermediary bank to the seller. Simply put, the intermediary upon receipt of the LoC issued by the buyer in its favour, the intermediary uses the LoC as a security to obtain a second LoC from its bank in favour of the Seller.

- **Standby LoCs (SBLC):** This acts as a secondary payment method; only drawn upon if the buyer fails to fulfill their payment obligations. It is an assurance from the bank of the buyer's ability to make payment to the seller.

5. Regulatory Framework in Nigeria

The regulatory framework governing LoCs in Nigeria is a combination of local laws, banking regulations, and international standards. This regulatory framework seeks to foster secure and efficient international trade. Key bodies like the Central Bank of Nigeria (CBN) and commercial banks oversee LoC transactions, while adherence to global practices such as the Uniform Customs and Practice for Documentary Credits (the "**UCP 600**") strengthens the country's trade finance system. This framework supports Nigerian businesses in engaging confidently in global markets.[18]

The UCP 600

The UCP 600 is the official publication which is issued by the International Chamber of Commerce (ICC). It is a set of 39 articles that govern how LoCs are issued and used, including the responsibilities of the parties involved. The UCP 600 is designed to ensure that LoCs are issued and used consistently and fairly, reducing risk of trading goods, providing clarity and certainty to all parties involved in a transaction and standardizing international trade. The UCP 600 which replaced UCP 500 with better and adaptable rules has been adapted in over 175 countries including Nigeria.[19]

While the UCP 600 rules are generally not legally binding and have to be specifically outlined in trade finance contracts in order to apply, the CBN in its circular dated June 25, 2007, informed all

[15] *UBN Ltd. v. Okwara* 1998) 1 NWLR (Pt. 532) p. 118 at 126 Para H; Akinkunmi Abolade, "Understanding Letters of Credit & The UCP 600 Rules in Nigeria" (February 9, 2024)
[16] *Akinsanya v UBA Ltd*. (1986) 4 NWLR (Pt. 35) 273.
[17] *supra*.
[18] Emmanuel Ifeanyi Ogbuka, "Relevant Provisions of the Dishonoured Cheques Act, Letters of Credit in Nigeria" (February 12, 2023) accessed at https://www.tekedia.com/relevant-provisions-of-the-dishonoured-cheques-act-letters-of-credit-in-nigeria/
[19] ICC, 'UN endorses ICC Documentary Credit Rules' (July 20, 2009) accessed at https://iccwbo.org/news-publications/news/un-endorses-icc-documentary-credit-rules/

authorized dealers, importers, and the public about the introduction of the UCP 600.[20] The circular stipulated that all LoCs from that date will be subject to the provisions of the UCP 600.

The CBN

The CBN is the apex regulatory authority overseeing banking and financial activities in Nigeria. As part of its mandate to regulate and control trade finance, the CBN has issued several circulars related to LoCs, *to wit*: the **(a)** *CBN **Circular Ref. No. TED/FEM/FPC/GEN/01/005** dated August 24, 2020* (which restricted authorized dealers from opening Form M in favour of procurement companies. It stated that Form "M" for letters of credit and other payments could only be opened for the ultimate suppliers of goods or services. The aim of this directive was to curb incidences of price manipulation, over-invoicing, cost duplication, and other practices); **(b)** *CBN **Circular Ref. No. TED/FEM/FPC/GEN/01/009** dated November 18, 2020* (which clarified the meaning of "ultimate supplier of products" to mean the direct party selling the goods to the importer irrespective of whether the party involved is the manufacturer or internationally recognised buying company/supplier/agent. It also specified that the name of the "ultimate supplier of products" should be the same as the beneficiary on the Form "M", invoice, bill of exchange, letter of credit instrument, and other relevant documents); and **(c)** CBN **Service Charter 2023 *Policy number: GVD-SC-02*** (which extended the processing time for the issuance of LoCs from 24 hours to five working days, due to the foreign exchange scarcity in Nigeria. The extension was designed to help businesses better manage their foreign exchange needs during a period of tight currency availability)[21] among others.

NOTE:

LoCs issued by a Nigerian bank (as the issuing bank) are generally governed by Nigerian contract law. See *U.B.N. Ltd. V. Osezuah.*[22] When disputes arise over the execution or enforcement of an LoC, these are resolved through the country's legal system. Many LoCs, however, stipulate that disputes will be resolved through arbitration, especially in international trade contracts, and arbitration rules often specify the use of internationally recognized arbitration bodies.

Also, banks in Nigeria must comply with the country's banking laws, including laws governing anti-money laundering (AML) and know-your-customer (KYC) practices.[23] These laws ensure that LoCs are not misused for illegal activities, and banks are required to verify the identities of all parties involved in the transaction.

In summary, the regulatory framework for LoCs in Nigeria is multifaceted, involving a blend of CBN regulations, international standards (UCP 600), Nigerian banking laws, import related regulations, and contract law. This comprehensive framework ensures that LoCs are used in compliance with both local and international trade norms, while providing mechanisms for dispute resolution through courts or arbitration, depending on the terms of the agreement.

6. Which Court has Jurisdiction to entertain disputes relating to LoCs?

In Nigeria, disputes relating to LoCs generally fall within the realm of commercial law and banking law. The court with jurisdiction to entertain such disputes typically depends on the nature of the case, but in most cases, it will be a specialized court with jurisdiction over commercial and banking matters.[24]

Section 251(1)(d) of the Nigerian Constitution provides that the Federal High Court has exclusive jurisdiction on matters connected with or pertaining to banking, banks, other financial institutions, including any action between one bank and another, any action by or against the Central Bank of Nigeria arising from banking, foreign exchange, coinage, legal tender, bills of exchange, letters of credit, promissory notes and other fiscal measures: *Provided that this*

[20] Introduction of the New Uniform Customs and Practice (UCP 600) For Documentary Credit
[21] Nairametrics, "CBN extends timeline for issuance of letters of credit to five working days as FX crisis persists in Nigeria" accessed at https://nairametrics.com/2023/12/07/cbn-extends-timeline-for-issuance-of-letters-of-credit-to-five-working-days-as-fx-crisis-persists-in-nigeria/
[22] (1997) 2 NWLR (PT. 485) 28 at 41F
[23] Money Laundering (Prevention and Prohibition) Act, 2022, Terrorism (Prevention) Act, 2022,etc.
[24] Except where the LOC stipulates that any dispute arising therefrom shall be resolved through arbitration.

paragraph shall not apply to any dispute between an individual customer and his bank in respect of transactions between the individual customer and the bank.

Also, section 251(1)(g) of the Nigerian Constitution further provides that the Federal High Court has exclusive jurisdiction on admiralty matters and matters that border on carriage by sea. These provisions seem to confer jurisdiction on the Federal High Court in light of the fact that LoCs seem to fall within the scope of banking, admiralty, and carriage by sea.

However, Nigeria's apex court has held that State High Courts are the courts with jurisdiction on matters that border on letters of credit. In *Nasaralai Enterprises Ltd. V. Arab Bank Nigeria Ltd.* (*supra*), the Supreme Court held that the State High Court and not the Federal High Court is the court with jurisdiction on issues that border on LoCs. In reaching its conclusion, the court noted that any dispute between an individual customer and his bank - "*is essentially a matter of documentary contract between a banker and his customer which has nothing to do with maritime law. It is a matter within the jurisdiction of the High Court and not of the Federal High Court"*

The Supreme Court noted that parties in a letter of credit deal in documents and not goods or ships.[25] As such, a State High Court is the appropriate court to institute an action in which a letter of credit is the subject of dispute. See also *F.B.N. Plc v. Standard Polyplastic Ind. Ltd.* (2022) 15 NWLR (Pt. 1854) 517; *Akinsanya v UBA Ltd*. (Supra); *Ubah et al. v. Fidelity Bank Plc* (2013) LPELR-20657(CA) Pp 22 - 40 Paras F – C.

7. Conclusion

An LoC is vital in international trade as it provides security for both buyers and sellers, ensuring payment once contractual terms are met. It mitigates risks such as non-payment, fraud, and currency fluctuations, while offering a reliable payment mechanism. For Nigerian businesses, using LoCs enhances confidence, facilitates market access, and strengthens relationships with international partners. It also supports easier financing by providing security to financial institutions. However, it is not without certain risks, including its high cost, complex procedures, and time-consuming nature. Additionally, there are risks such as currency fluctuations and the possibility of default by the issuing bank, which can add to the challenges.

Nonetheless, LoCs ultimately help boost Nigeria's export potential and align the country's trade finance practices with global standards.

[25] In this regard, the Supreme Court held that the breach by the seller for non-compliance with the credit has nothing to do with goods.

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