

Letters of indemnity and the bank's exposure

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When the original bills are not available at discharge, the shipowner delivers the cargo against a letter of indemnity (LOI) from the charterer or the seller, typically on the standard forms of the International Group of P&I Clubs. Chapter F.II explained the mechanics and the risks for the trader.¹ For the bank the LOI raises three questions. The first is whether it should countersign the LOI, as the standard forms recommend, which turns the bank into a guarantor of the shipowner against claims by the holder of the bills. A countersigned LOI is an off-balance sheet exposure that may last for years, until the limitation period for claims under the bills of lading has expired. The second question is whether delivery against an LOI destroys the bank's security. If the bank financed the cargo and holds the bills, delivery against the trader's LOI to a buyer who has not paid the bank leaves the bank with a document that no longer represents goods in the carrier's custody. The bank's remaining claim lies against the shipowner for misdelivery, and the shipowner's claim lies against the trader under the LOI. The third question is whether the buyer's payment will reach the bank. A trader who receives the sale proceeds into an account at another bank can divert them.

Several of the 2020 cases followed exactly this pattern: cargo released against LOIs to buyers who paid into accounts not controlled by the financing bank, or did not pay at all. The practical answer of the banks has been to restrict LOI delivery to buyers approved in advance. Banks now require that the sale proceeds be paid into a collection account held with them and that the trader assign the receivable to the bank and notify the buyer of the assignment. The bank keeps a register of open LOIs and monitors when they can be released. A trader that wants to keep its credit lines must accept these controls and build them into its sale contracts, for instance by requiring the buyer to pay into a specified account and to acknowledge the assignment of the receivable.

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Common misconception. It is often assumed that a bank which holds the original bills of lading is fully secured on the cargo. In practice the security can be lost when the cargo is delivered against a letter of indemnity, when the bills were issued in duplicate or for goods never loaded, or when the sale proceeds are paid to an account outside the bank's control. Possession of the bills is necessary for security over seaborne goods, but it is sufficient only when the bank also controls delivery, the identity of the buyer and the flow of payment.

1 Notes

1. See Chapter F.II (International Group of P&I Clubs, LOI forms A, B and C). ↩

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