

Letter of Credit (L/C) – What are the seller's remedies if a buyer fails to open an L/C under the CISG?

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I. INTRODUCTION

In international trade, offering extended payment terms can be extremely attractive to new foreign buyers and ultimately lead to winning more export sales. However, in order to offer such benefits, a seller needs to check the foreign buyer's credit which is not always easy to find. If the seller is unable to obtain reliable credit information, the L/C may be available to the exporter as a trade financing instrument.

An L/C is basically an undertaking by a bank to make payment to a beneficiary (usually the seller) within a specified time, against the presentation of documents which must be strictly in compliance with the terms of the L/C. L/Cs are very popular in international trade and described as "the life blood of international commerce".

This factsheet highlights the remedies available to a seller under the United Nations Convention on Contracts for the International Sale of Goods, Vienna 1980 (CISG) if a buyer fails to open an L/C.

II. WHEN DOES THE CISG APPLY?

The CISG is arguably the most widely accepted legal framework for international sales contracts. With harmonization as its central aim, the CISG offers a set of uniform rules that govern cross-border sales, enhancing predictability and reducing legal barriers in international commerce and, as a result, reducing transaction costs.

Whether a sales contract is subject to the CISG is decided according to Article 1 CISG. First of all, the parties' places of business must be in different states. If both are in contracting states, the contract is subject to the CISG (Article 1(1)(a) CISG).

According to Article 1(1)(b) CISG, the CISG also applies to contracts for the sale of goods between parties not domiciled in contracting states if the rules of private international law lead to the application of the law of a contracting state.

However, according to Article 6 CISG, the principle of freedom of contract applies. The parties are therefore free to choose the applicable law. If they do so, the applicable law must be determined according to their choice.

If the parties have chosen a law (e.g. Swiss law) without mentioning the CISG, then the question arises as to whether the CISG applies because such clauses do not expressly state whether they exclude the CISG.

The prevailing doctrine and case law agrees that the choice of the law of a contracting state is presumably not an implicit exclusion of the CISG as the CISG is part of each contracting state's national law. Rather, it is clear from the parties' choice of law that the CISG applies, but for any potential gap in the CISG, the chosen national law is used to fill the gap. The assumption of an implicit exclusion of the CISG would require further indications in the contract.

In cases where the CISG applies, it takes precedence over ordinary national law (e.g. Swiss Code of Obligations).

In general, Swiss law excluding the CISG is not necessarily more advantageous to a contracting party than the CISG, but the parties should be clear about what they are agreeing to by excluding or not excluding the application of the CISG.

III. REMEDIES FOR BREACH OF A PARTY'S DUTY TO OPEN AN L/C

The CISG offers an effective legal framework for the enforcement of a buyer's obligation to have a bank open an L/C under a contract for the international sale of goods.

According to Article 53 CISG, the buyer must pay the price for the goods and take delivery of them as required by the contract and the CISG. The provisions regarding payment of price can be found in Article 54 et seq. CISG.

Regarding the time of payment, Article 58 CISG is decisive. If the buyer is not bound to pay the price at any other specific time, the buyer must pay it when the seller places either the goods or documents controlling their disposition at the buyer's disposal (Article 58(1) CISG).

As Article 59 CISG expressly states, the buyer must pay the price on the date fixed or determinable from the contract without the need for any request or compliance with any formality on the part of the seller.

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The buyer will, therefore, be in breach of its obligation to pay the price without any notice needed from the seller.

In case the buyer does not open an L/C in due time, the buyer is in breach of its obligation to pay the price and the seller is entitled to the remedies according to Articles 61 et seq. CISG. These remedies include (i) a claim for specific performance, (ii) avoidance (termination) of the contract of sale and (iii) damages.

Request specific performance of an obligation to open an L/C

Under the CISG, a party has the right to require the other party to perform its obligations, unless the requesting party has chosen another remedy that is incompatible with specific performance (e.g., avoidance of the sales contract). Possible breaches giving rise to the remedy of avoidance include non-payment of the price and other obligations assumed under the contract, such as the opening of an L/C by the buyer. If the terms of an L/C differ from the agreed specifications, the seller may require the buyer to have a bank amend the nonconforming terms or issue a substitute L/C.

The buyer may be released from its obligation to open an L/C if there is an impediment beyond the control of the buyer or the bank and which was not foreseeable and unavoidable for either the buyer or the bank (force majeure / hardship).

Fixing an additional period of time to open an L/C

The seller may, pursuant to Article 63(1) CISG, set the buyer an additional period of time for the performance of its obligations. This provision also applies in the case of a contractual obligation to open a conforming L/C. If a conforming L/C is not opened within the additional period set by the seller, the seller is entitled to declare the contract avoided under Article 64(1)(b) CISG.

The grace period set for the buyer to issue a new L/C must be of reasonable length, depending on the circumstances of the specific case taking into account the banking practices at the buyer's domicile, national holiday, the nature of the agreed L/C and the payment structure (unconfirmed or confirmed L/C). The

issuance of a confirmed L/C may require a longer additional period of time than an unconfirmed L/C (confirming bank at the seller's place of business involved and approval from the issuing bank required).

Avoidance of the sales contract

Under Article 64(1)(a) CISG, the seller may declare the sales contract avoided if the buyer's failure to perform an obligation constitutes a fundamental breach. Under Article 25 CISG, a breach is fundamental if it results in such a detriment to the suffering party that it is substantially deprived of what it was entitled to expect under the contract and this result was or ought to have been foreseeable by the breaching party. The seller may also avoid the contract if the buyer fails to perform its obligation to pay the price within the additional period of time granted by the seller under Article 63(1)(b) CISG (see previous subsection).

In general, the question of whether the seller has the right to avoid the contract for fundamental breach of contract (Article 25 CISG) must be assessed on a case-by-case basis and should depend on the objective importance of the buyer's obligation to open a workable L/C in time.

Failure to open a workable L/C in time will most likely always constitute a fundamental breach. A delay may affect the seller's main expectation under a sales contract. This may be the case, for example, if the CISG contract provides that the seller has an immediate right to terminate the contract if the buyer fails to open the agreed L/C in time. The nature of the contract also may make the timely opening of a workable L/C an essential element. For example, if the L/C is linked to the seller's obligation to load the goods onto the ship, its proper and timely opening is essential, and the seller is entitled to avoid the contract for a minor delay or mistake in the L/C.

A fundamental breach of contract exists in any case if the buyer definitively refuses to open the agreed L/C.

If an L/C was opened on time, but not in accordance with the sales contract in other respects (e.g., the L/C does not provide for certain conditions agreed in the sales contract and the buyer refuses to have the L/C amended accordingly), this may also constitute a fundamental breach of contract.

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Damages

In general, if a buyer fails to perform any of its obligations under the contract or the CISG, the seller may claim damages. The breach does not have to be “fundamental” within the meaning of Article 25 CISG. The breach of any obligation by one of the parties, including the obligation to open an L/C, entitles the other party to claim damages which, according to the principle of full compensation, correspond to the financial loss suffered by the other party as a result of the breach. The recoverable damages include damages for non-performance, incidental and consequential damages resulting from the breach of the obligation to open an L/C. For example, if the delivery of the goods is dependent on the issuance of an L/C by the buyer's bank, the seller can claim as damages any additional storage costs resulting from a delay in delivery of the goods because the buyer did not open the L/C in time.

IV. RIGHT TO SUSPEND PERFORMANCE

Pursuant to Article 71(1) CISG, a party may suspend the performance of its obligations if, after the conclusion of the sales contract, it becomes apparent that the other party will not perform a substantial part of its obligations.

It is generally accepted that the buyer's failure to open an L/C in a timely manner is grounds for suspending the seller's obligation to deliver the goods or related documents.

A party's failure must, however, relate to a “substantial” part of that party's obligations. What may be considered a substantial part of a party's obligation has to be determined on a case-by-case basis. For example, an ICC arbitration tribunal ruled that the suspension of the claimant's obligation to open a L/C due to the seller's demand to increase the price of the last orders by 10 or 15 percent was inadmissible because it was “excessive and disproportionate”. The arbitral tribunal stated that the refusal to open an L/C is equivalent to a complete refusal to pay the purchase price and that since the disagreement only related to 10 or 15 percent of the price, the buyer could have at least advanced the undisputed amount.

The buyer is entitled to suspend its obligation to open an L/C if the seller has already failed to perform a related counter-obligation set out in the contract (for example, the obligation to send a notice of shipment in a CISG contract subject to certain Incoterms, by which the seller notifies the buyer that the agreed goods are available for transportation).

V. SUMMARY

The CISG offers an effective legal framework for the enforcement of a buyer's obligation to open an L/C under a contract for the international sale of goods.

A buyer's failure to have the agreed L/C opened by a bank constitutes a breach of contract. Accordingly, the seller may be entitled to some of the remedies provided by the CISG. These remedies include a request for specific performance, the avoidance of the sales contract and damages. In most cases, failure to open an L/C in a workable form or in a timely manner constitutes a fundamental breach of the sales contract and allows the seller to avoid the contract without granting the buyer a grace period. In the case of commodity sales contracts, which are often subject to strong price fluctuations and are negotiated by way of chain transactions, the timeliness of the document delivery is typically of particular importance.

Finally, it is generally accepted that the buyer's failure to open an L/C in a timely manner is grounds for suspending the seller's obligation to deliver the goods or related documents.

VI. OUR SERVICES

We advise and assist clients (especially commodity trading companies) in cross-border transactions involving L/Cs. In particular, we represent clients in L/C dispute proceedings before courts and arbitral tribunals.

Should you have any questions, please do not hesitate to contact us.