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LETTERS OF CREDIT: THE ROLE OF ISSUER DISCRETION IN DETERMINING DOCUMENTARY COMPLIANCE

INTRODUCTION

The letter of credit¹ developed in response to the need for assured payment in commercial transactions.² The letter of credit arrangement typically involves three parties: the issuer, usually a bank;³ the customer, usually the buyer of merchandise;⁴ and the beneficiary of the letter of credit, the seller.⁵ The buyer and seller enter into a contract for the sale

1. A letter of credit is "an engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit." U.C.C. § 5-103(1)(a) (1977); see International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits (UCP), art. 2 (Publ. No. 400) (rev. ed. 1983) [hereinafter cited as U.C.P.]; J. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* ¶ 2.03, at 2-4 (1984).

In addition to the issuing or opening bank, the transaction often involves a second bank, either an advising or a confirming bank, typically a correspondent of the issuer in the locality of the beneficiary. *Id.* ¶ 1.03, at 1-11; see T. Quinn, *Uniform Commercial Code Commentary and Law Digest* ¶ 5-103[A][4], at 5-15 (1978); International Chamber of Commerce, *Guide to Documentary Credit Operations* 7 (1978) [hereinafter cited as *Guide to Documentary Credit Operations*]. The role of the advising bank is limited: It merely "gives notification of the issuance of a credit by another bank." U.C.C. § 5-103(1)(e) (1977); see 2 A. Squillante & J. Fonseca, *The Law of Modern Commercial Practices* §§ 7:3, at 229, 7:7, at 234 (rev. ed. 1981) (advising bank is not primarily liable). The confirming bank, on the other hand, actually assumes the responsibility of reviewing the documentary presentment and honoring the draft. The confirming bank is then reimbursed by the issuer. See U.C.C. §§ 5-103(1)(f), 5-114(3) (1977); A. Squillante & J. Fonseca, *supra*, § 7:8, at 235.

There are two types of letters of credit: the commercial credit and the standby credit. The commercial credit is employed in a sale of merchandise; it serves to ensure payment to the seller of the goods. See J. Dolan, *supra*, at A-34. The standby credit serves a purpose similar to that of a guaranty by providing payment to a beneficiary upon default of a party that was obliged to perform. *Id.* ¶ 1.04, at 1-12 to -15. This Note focuses on the commercial credit, but its analysis is applicable to the standby credit.

2. See J. White & R. Summers, *Handbook on the Law Under the Uniform Commercial Code* § 18-1, at 704-05 (2d ed. 1980); Harfield, *Identity Crises in Letter of Credit Law*, 24 *Ariz. L. Rev.* 239, 241 (1982) [hereinafter cited as Harfield I]; Joseph, *Letters of Credit: The Developing Concepts and Financing Functions*, 94 *Banking L.J.* 816, 816 (1977); Mentschicoff, *How to Handle Letters of Credit*, 19 *Bus. Law.* 107, 111 (1963); see also *Venizelos, S.A. v. Chase Manhattan Bank*, 425 F.2d 461, 464 (2d Cir. 1970) (primary purpose of the letter of credit is to provide assurance); *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 173 *Conn.* 492, 499, 378 A.2d 562, 566 (1977) (letter of credit provides beneficiary with "assured, prompt payment from a solvent party").

3. "Issuer" is defined as "a bank or other person issuing a credit." U.C.C. § 5-103(1)(c) (1977). The issuer need not be a bank, see *id.*, but it is essential to the transaction that the issuer be a party of known solvency, see B. Kozolchyk, *Commercial Letters of Credit in the Americas* § 1.01[3], at 9 (1966).

4. The customer, or account party, is "a buyer or other person who causes an issuer to issue a credit." U.C.C. § 5-103(1)(g) (1977); see *Edgewater Constr. Co. v. Percy Wilson Mortgage & Fin. Corp.*, 44 *Ill. App. 3d* 220, 227, 357 N.E.2d 1307, 1313 (1976); H. Harfield, *Bank Credits and Acceptances* 33 (5th ed. 1974).

5. The beneficiary of a credit is the "person who is entitled under its terms to draw or demand payment." U.C.C. § 5-103(1)(d) (1977); see *Housing Sec., Inc. v. Maine Nat'l*

of goods and the buyer has the bank issue a letter of credit in the seller's favor.⁶ The letter constitutes "a formal promise by a bank or another party of known solvency . . . to pay the draft or the demand for payment by a beneficiary, whose compliance with the terms of the credit is a prerequisite of the enforceability of the promise."⁷ The terms, set by the customer,⁸ might include the presentation of a variety of documents, depending upon the parties' individual needs.⁹ Once the beneficiary makes his demand for payment, the bank is obliged to review the documents presented and honor the draft if the presentment complies with the terms of the credit.¹⁰ Upon honoring the draft, the bank is entitled to immedi-

Bank, 391 A.2d 311, 315-16 (Me. 1978); U.C.P., *supra* note 1, art. 2. The beneficiary is usually the seller of the merchandise. *See, e.g.*, *Empire Abrasive Equip. Corp. v. H.H. Watson, Inc.*, 567 F.2d 554, 556 (3d Cir. 1977) (seller of cabinets had buyer secure payment through issuance of a credit); *Vazman, S.A. v. Fidelity Int'l Bank*, 418 F. Supp. 1084, 1085 (S.D.N.Y. 1976) (credit issued in favor of seller of cement).

6. *See* B. Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶ 8.1[1], at 8-3 (rev. ed. 1981); J. Dolan, *supra* note 1, ¶ 1.01[3], at 1-5 to -6.

7. B. Kozolchik, *supra* note 3, § 1.01[3], at 9; *see* Rutcofsky, *Letters of Credit in Bankruptcy*, in *Credit Manual of Commercial Laws*, 1983, at xxii (1983); Note, *Letters of Credit: A Solution to the Problem of Documentary Compliance*, 50 *Fordham L. Rev.* 848, 869 (1982) [hereinafter cited as *A Solution to the Problem of Documentary Compliance*]; *see also* U.C.C. § 5-103 comment 1 (1977) (defining "engagement" as used in § 5-103 as "a promise to honor"); *cf.* 6 *Michie on Banks and Banking* § 31, at 414 (perm. ed. 1975) ("Letters of credit do not usually contain a direct promise to pay; but such promise is implied or inferred from the statement that the credit has been established and is irrevocable.").

8. The customer submits an application to the bank for issuance of the credit. The application is usually drafted by the bank and takes the form of a contract of adhesion. *See* J. Calamari & J. Perillo, *The Law of Contracts* § 1-3, at 6 (2d ed. 1977) (a contract of adhesion is a standardized form). *See* T. Quinn, *supra* note 1, ¶ 5-101[A][1][b], at 5-2 to -3. For a sample application, *see* J. Dolan, *supra* note 1, at A-77 to -85. The application sets the terms and conditions of the agreement between the customer and the issuer and is referred to as the application agreement. J. Dolan, *supra* note 1, ¶ 2.01, at 2-2. The customer is required to specify in the application the documents to be presented by the beneficiary. *Guide to Documentary Credit Operations*, *supra* note 1, at 8; McLaughlin, *Letters of Credit and Warehouse Receipts*, N.Y.L.J., Sept. 8, 1982, at 1, col.1; *e.g.*, J. Dolan, *supra* note 1, at A-75; A. Lowenfeld, *International Private Trade DS 77* (2d ed. 1981).

9. *See* H. Harfield, *supra* note 4, at 57. *See infra* note 24.

10. "An issuer must examine documents with care so as to ascertain that on their face they appear to comply with the terms of the credit . . ." U.C.C. § 5-109(2) (1977). The issuer must honor a draft that complies with the terms of the credit without looking to the underlying contract between the customer and the beneficiary. *Id.* § 5-114(1); *see* *Marino Indus. Corp. v. Chase Manhattan Bank*, 686 F.2d 112, 115 (2d Cir. 1982); *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 15 (2d Cir. 1979); *East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co.*, 593 F.2d 598, 602 (5th Cir. 1979); *Bossier Bank & Trust Co. v. Union Planters Nat'l Bank*, 550 F.2d 1077, 1080 (6th Cir. 1977); *Fidelity Bank v. Lutheran Mut. Life Ins. Co.*, 465 F.2d 211, 214 (10th Cir. 1972); *Cappaert Enters. v. Citizens & S. Int'l Bank*, 486 F. Supp. 819, 826 (E.D. La. 1980); *Prudential Ins. Co. of Am. v. Marquette Nat'l Bank*, 419 F. Supp. 734, 736 (D. Minn. 1976); *West Va. Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1114 (W.D. Pa. 1976); *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 173 Conn. 492, 497-99, 378 A.2d 562, 565-66 (1977); *Maurice O'Meara Co. v. National Park Bank*, 239 N.Y. 386, 395-96, 146 N.E. 636, 639 (1925); J. Dolan, *supra* note 1, ¶ 6.01, at 6-2; Note, *The Application of Comput-*

ate reimbursement by the customer.¹¹

By substituting a bank's credit for the buyer's credit,¹² the letter of credit theoretically eliminates three major risks otherwise imposed on the seller in the documentary sale.¹³ First is the insolvency risk.¹⁴ If the buyer is unable to pay for the merchandise, the seller will be forced to dispose of the goods, often in a market that is foreign to him.¹⁵ In addition, any cause of action by the seller for damages would provide no relief in the case of buyer insolvency. Second, the seller faces the dishonesty risk. The buyer may wrongfully refuse payment, especially when he discovers a better bargain elsewhere due to a decline in market prices.¹⁶ Finally, there is the honest-dispute risk. The buyer may refuse payment for a legitimate reason, such as nonconformity of a prior shipment.¹⁷ The bank's role in objectively reviewing the documents without looking to the underlying contract between the buyer and the seller¹⁸ promotes a greater willingness on the part of parties with little or no previous acquaintance to enter into commercial transactions.¹⁹ The effective opera-

sory Joinder, Intervention, Impleader and Attachment to Letter of Credit Litigation, 52 Fordham L. Rev. 957, 966-67 (1984).

11. U.C.C. § 5-114(3) (1977); see J. Dolan, *supra* note 1, ¶ 7.05, at 7-53 to -54; see also B. Clark, *supra* note 6, ¶ 8.11, at 8-72 ("reimbursement most frequently takes the form of debiting the customer's demand deposit account, or other direct payment, but it can be deferred under a credit arrangement between issuer and customer").

12. See, e.g., *Insurance Co. of N. Am. v. Heritage Bank, N.A.*, 595 F.2d 171, 173 (3d Cir. 1979) (per curiam); *H. Ray Baker, Inc. v. Associated Banking Corp.*, 592 F.2d 550, 552-53 (9th Cir.), *cert. denied*, 444 U.S. 832 (1979); *West Va. Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1112 (W.D. Pa. 1976); *National Sur. Corp. v. Midland Bank & Trust Co.*, 408 F. Supp. 684, 690 (D.N.J. 1976), *rev'd on other grounds*, 551 F.2d 21 (3d Cir. 1977); *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 173 Conn. 492, 499, 378 A.2d 562, 566 (1977); see *Continental Nat'l Bank v. National City Bank*, 69 F.2d 312, 316 (9th Cir.), *cert. denied*, 293 U.S. 557 (1934); *Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank*, 387 F. Supp. 92, 98 (M.D.N.C. 1975), *rev'd on other grounds*, 528 F.2d 802 (4th Cir. 1975); H. Harfield, *supra* note 4, at 27, 44.

13. A documentary sale allows the seller to receive payment for merchandise before the buyer takes possession. This is accomplished by requiring the buyer to pay "cash against documents" rather than cash upon receipt of the goods. See J. White & R. Summers, *supra* note 2, § 18-1, at 704-05; see also U.C.C. § 2-319(4) (1977) (F.O.B. and F.A.S. contracts); *id.* § 2-320(4) (C.I.F. and C. & F. contracts). The documentary sale protects the seller from the risk that the buyer will receive the goods and later refuse payment. See A. Lowenfeld, *supra* note 8, § 1.1.

14. See 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:3, at 227; J. White & R. Summers, *supra* note 2, § 18-1, at 706; Harfield I, *supra* note 2, at 241.

15. J. White & R. Summers, *supra* note 2, § 18-1, at 706.

16. See G. Gilmore & C. Black, *The Law of Admiralty* 121 (2d ed. 1975). The insolvency risk and the dishonesty risk have not been eliminated completely by the letter of credit. See *infra* notes 41, 121 and accompanying text. Buyer's insolvency and dishonesty often lead to examination of the documentary presentment that is unfavorable to the beneficiary. See *infra* notes 41, 121 and accompanying text.

17. J. White & R. Summers, *supra* note 2, § 18-1, at 706; see B. Clark, *supra* note 6, ¶ 8.1[1], at 8-3.

18. See *supra* note 10 and accompanying text.

19. The letter of credit is often employed in international sales, where the parties' distance makes it difficult for the seller to monitor the conduct and financial status of the buyer. See A. Lowenfeld, *supra* note 8, § 5.3, at 130; Joseph, *supra* note 2, at 816-17.

tion of the letter of credit, however, requires that the parties understand and carry out their duties under the arrangement.

Each party's obligation is triggered by the beneficiary's demand for payment.²⁰ The issuer's refusal to pay a complying presentment constitutes wrongful dishonor for which the beneficiary has a remedy at law.²¹ Likewise, payment when the documents are noncomplying imposes on the issuer contractual liability to the customer.²² Thus, the issue most frequently litigated is whether the documents presented comply with the terms of the credit.²³ Documentary discrepancies are inevitable in light of the variety of documents required.²⁴ The customer is encouraged to set specific terms,²⁵ but the likelihood of less-than-exact compliance increases with the degree of specificity.²⁶

Recognizing the importance of flexibility in the development of letter of credit law, the drafters of the Uniform Commercial Code declined to establish a rigid rule of compliance.²⁷ Instead, the U.C.C. provides that

The domestic use of the letter of credit, however, has increased considerably. See Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C. L.J. 251 (1972). The growing popularity of the letter of credit is attributable to its adaptability in commercial transactions. In addition to its payment function, the letter of credit has a secondary financing function: The beneficiary can finance underlying transactions by assigning rights to proceeds under the letter of credit. J. White & R. Summers, *supra* note 2, § 18-1, at 708; *id.* § 18-9, at 752; see Harfield, *Secondary Uses of Commercial Credits*, 44 Colum. L. Rev. 899, 908 (1944); Joseph, *supra* note 2, at 818-19; see also Guide to Documentary Credit Operations, *supra* note 1, at 32 (description of the "back-to-back" credit).

20. See U.C.C. § 5-114(1)-(3) (1977) (issuer must pay complying presentment and upon payment is entitled to immediate reimbursement from its customer); J. Dolan, *supra* note 1, ¶ 2.01, at 2-2.

21. See U.C.C. § 5-115(1) (1977). The beneficiary's recovery for wrongful dishonor by an issuer includes the face amount of the draft, incidental damages and interest, less any amount realized by disposition of the goods. *Id.*

22. H. Harfield, *supra* note 4, at 105; see 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:17, at 265.

23. 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:25, at 277; Comment, *Letters of Credit: Current Theories and Usages*, 39 La. L. Rev. 581, 597 (1979) [hereinafter cited as *Current Theories and Usages*]; see Megrah, *Risk Aspects of the Irrevocable Documentary Credit*, 24 Ariz. L. Rev. 255, 255 (1982).

24. Documents ordinarily required in addition to the draft include the seller's commercial invoice, a bill of lading and an insurance policy. H. Harfield, *supra* note 4, at 57. There may, however, be additional requirements such as a consular invoice, a certificate of weight or quality, and import or export licenses. *Id.*

25. See T. Quinn, *supra* note 1, ¶ 5-114[A][8], at S5-24 (Cum. Supp. No. 2 1984). The customer in the letter of credit transaction is likely to protect himself by requiring specific documents such as an inspection certificate. Absent such requirements, the buyer exposes himself to substantial risks because the beneficiary/seller will have received payment under the letter of credit before the customer has even had the opportunity to examine the goods. See J. Dolan, *supra* note 1, ¶ 3.07[5], at 3-28. But see U.C.P., *supra* note 1, art. 5 (advising issuing banks to "discourage any attempt by the [customer] . . . to include excessive detail").

26. See G. Gilmore & C. Black, *supra* note 16, at 121 ("it would be a rare set of documents that could meet the impossible standards of purity which the theory demands"). Where there is a series of documents required, there is an increasing chance that they will not conform precisely with the credit terms. See *id.* at 121-22.

27. See U.C.C. § 5-102 official comment 2 (1977). The drafters of the Uniform Com-

the documents presented must "on their face . . . appear to comply with the terms of the credit."²⁸ The task of formulating an appropriate standard of compliance was delegated specifically to the judiciary.²⁹ Divergent views of the courts as to the interests in need of protection have resulted in the evolution of three different standards of compliance: strict compliance, substantial compliance and a hybrid standard employing both strict and substantial compliance.

Many courts insist that anything less than strict or exact compliance is insufficient.³⁰ While recognizing the harshness to beneficiaries whose documents contain only slight discrepancies,³¹ the advocates of strict compliance defend it as the only way to ensure certainty in the transaction.³² Simple classification of every document as either complying or noncomplying obviates the need to inquire into the materiality of the discrepancy, thus rendering the issuer's function purely ministerial.³³

Other courts have acknowledged the need for strict compliance but allow for substantial or reasonable compliance in certain situations.³⁴ For example, if the terms of the credit require presentment of several

mercial Code (U.C.C.) noted that "[t]he more important areas not covered by [Article Five] revolve around the question of when documents in fact and in law do or do not comply with the terms of the credit." *Id.*; see Note, *Judicial Development of Letters of Credit Law: A Reappraisal*, 66 Cornell L. Rev. 144, 151 & n.40 (1980) [hereinafter cited as *Judicial Development*].

28. U.C.C. § 5-109(2) (1977).

29. See *id.* § 5-102 official comment 2.

30. See, e.g., *Philadelphia Gear Corp. v. Central Bank*, 717 F.2d 230, 236 (5th Cir. 1983); *Marino Indus. Corp. v. Chase Manhattan Bank*, 34 U.C.C. Rep. Serv. (Callaghan) 637, 640 (2d Cir. 1982); *Insurance Co. of N. Am. v. Heritage Bank*, 595 F.2d 171, 175 (3d Cir. 1979) (per curiam); *Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank*, 528 F.2d 802, 805-06 (4th Cir. 1975); *AMF Head Sports Wear, Inc. v. Ray Scott's All-Am. Sports Club, Inc.*, 448 F. Supp. 222, 223 (D. Ariz. 1978); *Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank*, 356 F. Supp. 991, 995 (N.D. Ga. 1973); see *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 862; *Judicial Development*, *supra* note 27, at 151.

31. See *Insurance Co. of N. Am. v. Heritage Bank*, 595 F.2d 171, 175 (3d Cir. 1979) (per curiam); *AMF Head Sports Wear, Inc. v. Ray Scott's All-Am. Sports Club, Inc.*, 448 F. Supp. 222, 225 (D. Ariz. 1978); *J. Dolan*, *supra* note 1, ¶ 4.08[2], at 4-36; *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 870.

32. See *J. Dolan*, *supra* note 1, ¶ 4.08[2], at 4-36; *Derrick, An Issuing Bank's Duty of Payment Under An Irrevocable Letter of Credit: Asociacion de Azucareros de Guatemala v. United States National Bank of Oregon*, 12 Ariz. L. Rev. 835, 836 (1970); *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 875-76.

33. *Insurance Co. of N. Am. v. Heritage Bank*, 595 F.2d 171, 173 (3d Cir. 1979) (per curiam); *Dulien Steel Prods., Inc. v. Bankers Trust Co.*, 298 F.2d 836, 840-41 (2d Cir. 1962); *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 859; *McLaughlin*, *supra* note 8, at 1, col. 1.

34. See, e.g., *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 699, 705 (1st Cir. 1978); *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F.2d 230, 237 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968); *Crocker Commercial Servs. v. Countryside Bank*, 538 F. Supp. 1360, 1362-63 (N.D. Ill. 1981); *First Arlington Nat'l Bank v. Stathis*, 90 Ill. App. 3d 802, 814-16, 413 N.E.2d 1288, 1298-99 (1980); *First Nat'l Bank v. Wynne*, 149 Ga. App. 811, 814-15, 256 S.E.2d 383, 385 (1979); see *J. Dolan*, *supra* note 1, ¶ 4.08[2], at 4-35 to -36.

documents, and one of the documents presented varies slightly from the terms, the issuer could honor the draft if compliance could be gleaned from the documents viewed in the aggregate.³⁵

Finally, some courts apply a bifurcated standard imposing strict compliance when the beneficiary sues the issuer but substantial compliance when the customer sues the issuer.³⁶ These courts reason that by vesting some discretionary power in the bank, greater equity will be achieved with regard to the beneficiary.³⁷

The inability of courts to agree upon a uniform standard is attributable primarily to disagreement over one fundamental issue: the extent to which the notions of "equity" and "substantiality" recognized in contract law should be relevant in the determination of compliance.³⁸ Part I of this Note examines the problems encountered by courts in applying the standards of strict and substantial compliance. It concludes that in order to reconcile the contractual notions of substantiality and equity with the need for certainty, it is necessary to define the duties imposed on the parties by virtue of their relationships. Part II urges that the contractual relationship between the issuer and the beneficiary be recognized as analogous to that of the parties to an option contract. Part III argues that the bifurcated standard, because it vests discretionary power in the bank, can most equitably and effectively achieve the goals of the letter of credit. The proper exercise of discretionary power can only be realized, however, when combined with the contractual duties that arise under the issuer/beneficiary relationship.

35. See *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 699, 703 (1st Cir. 1978) ("a case of the greater including the smaller"); *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967) ("[n]ot only does *haec verba* not control absolutely, . . . but some courts now cast their eyes on a wider scene than a single document") (citation omitted), *cert. denied*, 390 U.S. 1013 (1968); 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:25, at 279 (individual documents submitted by the beneficiary should be read together in determining compliance with the terms of the credit).

36. J. White & R. Summers, *supra* note 2, § 18-6, at 731-32 (quoting 3 State of N.Y. Law Revision Comm'n, Study of the Uniform Commercial Code: Article 5—Documentary Letters of Credit, Legislative Doc. No. 65(F), at 66-67 (1955) [hereinafter cited as New York Study], *reprinted in* 3 State of N.Y. Law Revision Comm'n, Report of the Law Revision Comm'n for 1955, at 1634-35 [hereinafter cited as 1955 Report]); see, e.g., *Transamerica Delaval Inc. v. Citibank*, 545 F. Supp. 200, 203-04 (S.D.N.Y. 1982); *Far E. Textile, Ltd. v. City Nat'l Bank & Trust Co.*, 430 F. Supp. 193, 196 (S.D. Ohio 1977); see J. Dolan, *supra* note 1, ¶ 9.03[1][a], at 9-22 to -24; T. Quinn, *supra* note 1, ¶ 5-114[A][8], at S5-22 to -24 (Cum. Supp. No. 2 1984); see also *Bank of Cochin, Ltd. v. Manufacturers Hanover Trust Co.*, No. 183 Civ. 1767, slip op. at 13-15 (S.D.N.Y. July 9, 1985) (discussing the bifurcated standard but noting that it is only a suggested approach that has not actually been followed by New York Courts).

37. See New York Study, *supra* note 36, at 66-67, *reprinted in* 1955 Report, *supra* note 36, at 1634; T. Quinn, *supra* note 1, ¶ 5-114[A][8], at S5-23 (Cum. Supp. No. 2 1984).

38. See Harfield I, *supra* note 2, at 242; *Judicial Development*, *supra* note 27, at 166.

I. DETERMINING THE APPROPRIATE STANDARD OF COMPLIANCE

Analysis of the following hypothetical will illustrate the concerns of the courts in determining an appropriate standard of compliance. S agrees to sell and B to buy 100 tons of cashews. S, never having dealt with B and wishing to avoid the risks of non-payment,³⁹ requests that B have a letter of credit issued. B has Bank X issue a letter of credit in S's favor. The terms of the credit are: "100 tons cashews." Documents to be presented are: draft, bill of lading, invoice and certificate of inspection. Expiration date is April 10, 1986. Upon shipping the goods, S sends the required documents to the bank. The documents are received on April 8. The invoice and certificate of inspection state "100 tons cashews," whereas the bill of lading states "100 tons nuts." In most cases, the customer would have no reason to object to the discrepancy because he is eager to receive the merchandise.⁴⁰ In this case, however, B becomes insolvent⁴¹ or, alternatively, there has been a drastic decline in the market price of cashews. Bank X, aware of B's misfortune, now fears that it will not be reimbursed if it honors the draft.⁴² What should the bank do?

A. *Strict Compliance: The Safety Valve*

The standard of strict compliance affords the greatest protection to the bank and its customer. Under this standard, the bank is obliged to pay only when the documents presented conform exactly with the terms of the credit.⁴³ Thus, the beneficiary in the hypothetical would be denied payment.

The inequity of this outcome is twofold. First, the beneficiary is denied payment even though a closer reading of the documents indicates that there has been compliance with the terms of the credit. In the situation described, only the description in the bill of lading varies from the terms of the credit. The bill of lading is a shipping document provided by a party with very little knowledge about the actual content of the

39. See *supra* notes 13-17 and accompanying text.

40. See T. Quinn, *supra* note 1, ¶ 5-101[A][3], at 5-5.

41. See *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 699, 702 (1st Cir. 1978) (buyer became bankrupt and sought to avoid payment).

42. The major question "from the issuer's point of view [is] whether the customer will reimburse the issuer for the payment which has been made." Mentschicoff, *supra* note 2, at 110.

43. See McLaughlin, *supra* note 8, at 1, col. 1. See *supra* note 30 and accompanying text. Courts have held that any discrepancy, regardless of its materiality, would justify the bank's dishonor of the draft. See, e.g., *Bank of Italy v. Merchants Nat'l Bank*, 236 N.Y. 106, 108-09, 140 N.E. 211, 211-12 (1923) ("raisins" vs. "dried grapes"), *cert. denied*, 264 U.S. 581 (1924); *Oriental Pac. (U.S.A.), Inc. v. Toronto Dominion Bank*, 78 Misc. 2d 819, 820, 357 N.Y.S.2d 957, 958-59 (Sup. Ct. 1974) ("woolen knitweaves" versus "ladies' sweaters, dresses, pants and skirts"); *J.H. Rayner & Co. v. Hambros Bank, Ltd.*, [1943] 1 K.B. 37, 40 (C.A.) ("machine-shelled groundnut kernals" versus "Coromandel groundnuts"); *Equitable Trust Co. v. Dawson Partners*, 27 Lloyd's List L.R. 49, 52 (1927) ("[t]here is no room for documents which are almost the same, or which will do just as well").

shipment.⁴⁴ The invoice and certificate of inspection, on the other hand, are submitted by the manufacturer and the appointed inspector respectively, both of whom have examined the merchandise.⁴⁵ When the documents are reviewed objectively, refusal to honor seems unjustified.⁴⁶ Second, even if the bank were to determine that there was documentary compliance, it would nevertheless be prohibited from honoring the draft under the strict compliance standard because it would be liable to its customer for breach of contract.⁴⁷

The seller's only remedy in the hypothetical would be to sue the customer directly on the underlying contract.⁴⁸ Requiring the seller to pursue a cause of action against the customer imposes on him the very risks sought to be avoided in employing the letter of credit as a payment device.⁴⁹ Insistence on strict compliance does not merely raise a question of hardship; it threatens to undermine the very purpose of the letter of credit.⁵⁰

Some commentators have acknowledged,⁵¹ and even applauded,⁵² the

44. The bill of lading is "the carrier's receipt for what he has received for shipment as well as his contract for carriage." H. Harfield, *supra* note 4, at 75 (footnote omitted); *see, e.g.,* J. Dolan, *supra* note 1, at A-66 to -70; A. Lowenfeld, *supra* note 8, at DS-72 to -73.

45. The commercial invoice is the "seller's representation as to the merchandise sold." H. Harfield, *supra* note 4, at 75. The certificate of inspection is a representation of a third party who examines and attests to the quantity or quality of the goods. *See id.* at 67-68.

46. In the landmark case, *Laudisi v. American Exch. Nat'l Bank*, 239 N.Y. 234, 146 N.E. 347 (1924), the New York Court of Appeals addressed the issue presented in the hypothetical, holding that the bank's payment was justified although the invoice described the goods as "Alicante Bouchez grapes" and the bill of lading merely stated "grapes." *Id.* at 238, 146 N.E. at 348. *But see* *J.H. Rayner & Co. v. Hambros Bank Ltd.*, [1943] 1 K.B. 37, 40 (court upheld dishonor where terms of the bill of lading varied slightly from the terms of the invoice).

The U.C.P. states that "[t]he description of the goods in the commercial invoice must correspond with the description in the credit. In all other documents, the goods may be described in general terms not inconsistent with the description of the goods in the credit." U.C.P., *supra* note 1, art. 41(c). The U.C.P. does not have the force of law, however. H. Harfield, *supra* note 4, at 225, 227. It is a series of fairly generalized rules. *Id.* at 225-26. Like the U.C.C., *see supra* notes 27-29 and accompanying text, the U.C.P. does not establish any absolute rule and is therefore subject to interpretation by parties to the transaction and by the courts. *See* B. Kozolchyck, *supra* note 3, at 88; *Judicial Development*, *supra* note 27, at 148 n.28. Thus, the outcome of the hypothetical under the U.C.P. remains unclear: the court will still be compelled to reconcile the rule of strict compliance with the general language of the U.C.P.

47. *See supra* note 22 and accompanying text.

48. *Cf.* 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:5, at 231 (letter of credit does not vary rights of parties to the underlying contract).

49. *See supra* notes 13-17 and accompanying text.

50. *See supra* notes 12-19 and accompanying text.

51. *See* B. Kozolchyck, 9 Int'l Encycl. of Comp. Law 82 (1979) ("customers have a marked propensity to find deviations from strict compliance whenever there is a sharp drop in the market price of the goods purchased") [hereinafter cited as Kozolchyck I]; McLaughlin, *supra* note 8, at 2, col. 1 (noting the argument of advocates of reasonable compliance that "[s]trict compliance inevitably leads to nit-picking and to hypertechnical parsing of language by letter of credit issuers intent on extricating themselves from payment obligations").

application of the strict compliance standard as illustrated in the hypothetical. Others have sought an application of the standard that would yield more equitable results, primarily through the use of the doctrines of waiver and estoppel.⁵³ The bank may consult the customer when it has received documents that do not comply exactly.⁵⁴ The customer may then choose to waive the discrepancy, thereby authorizing payment under the letter. Although the doctrine may be beneficial in some situations,⁵⁵ it would be of no value where the customer seeks to extricate itself from its payment obligation.⁵⁶

A second possible solution would be to require the issuer either to make full disclosure to the beneficiary of all documentary defects at the time of honor or dishonor or be estopped from raising them at trial.⁵⁷ Ideally, such disclosure would allow the beneficiary to cure the defects.⁵⁸

52. See G. Gilmore & C. Black, *supra* note 16, at 121.

At least in theory the bank must reject a tender which deviates in the slightest degree from the ideal. In practice the rule is modified from necessity: it would be a rare set of documents that could meet the impossible standards of purity which the theory demands, and credits are, after all, designed to facilitate payments, not to serve as escape hatches for buyers who have repented of their bargains. Nevertheless, at a time of sharp market breaks, a bank officer who cannot, at his customer's request, discover some plausible reason for dishonoring drafts is hardly worthy of the name.

Id. (emphasis added) (footnote omitted). But see T. Quinn, *supra* note 1, ¶ 5-101[A][3], at 5-6 ("[w]hen the documents appear on their face to comply with the credit but the bank's customer notifies it that there is a serious shortage in the goods . . . the bank must nevertheless honor the draft").

53. See *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 870-74; McLaughlin, *supra* note 8, at 2, col. 2.

54. Banks often do consult with their customers when they deem waiver of a discrepancy to be appropriate. See New York Study, *supra* note 36, at 73, reprinted in 1955 Report, *supra* note 36, at 1641; B. Kozolchych, *supra* note 3, at 81; J. White & R. Summers, *supra* note 2, § 18-6, at 733.

55. J. White & R. Summers, *supra* note 2, § 18-6, at 732-33; see *Corporacion de Mercadeo Agricola v. Mellon Bank Int'l*, 608 F.2d 43, 46-47 (2d Cir. 1979); *Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank*, 528 F.2d 802, 806-07 (4th Cir. 1975); *International Leather Distribs., Inc. v. Chase Manhattan Bank*, 464 F. Supp. 1197, 1201 (S.D.N.Y.), *aff'd mem.*, 607 F.2d 996 (2d Cir. 1979); *North Am. Foreign Trading Corp. v. General Elecs., Ltd.*, 67 A.D.2d 890, 891-92, 413 N.Y.S.2d 700, 702 (1979) (mem.).

56. See G. Gilmore & C. Black, *supra* note 16, at 121. Moreover, under present law, the customer does not have a good faith obligation to waive immaterial discrepancies in the documentary presentment. *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 875.

57. Some courts have insisted on such disclosure. See, e.g., *Marino Indus. Corp. v. Chase Manhattan Bank*, 686 F.2d 112, 117-19 (2d Cir. 1982); *Corporacion de Mercadeo Agricola v. Mellon Bank Int'l*, 608 F.2d 43, 48-49 (2d Cir. 1979); *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1224, 1236 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974); *Crocker Commercial Servs., Inc. v. Countryside Bank*, 538 F. Supp. 1360, 1363 (N.D. Ill. 1981); *American Employers Ins. Co. v. Pioneer Bank & Trust Co.*, 538 F. Supp. 1354, 1357 (N.D. Ill. 1981); *Bank of Canton, Ltd. v. Republic Nat'l Bank*, 509 F. Supp. 1310, 1317 (S.D.N.Y.), *aff'd*, 636 F.2d 30 (2d Cir. 1980); *Data Gen. Corp. v. Citizens Nat'l Bank*, 502 F. Supp. 776, 785-86 (D. Conn. 1980); *U.S. Indus. v. Second New Haven Bank*, 462 F. Supp. 662, 665-66 (D. Conn. 1978).

58. See *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 871-73; McLaughlin, *supra* note 8, at 2, cols. 2-4.; see also U.C.P., *supra* note 1, art. 16(e) (if

A problem arises, however, when there is insufficient time to cure the defects before the expiration of the credit. For example, the documents in the hypothetical were presented two days before the expiration date. Even if the discrepancy were immediately discovered by the bank, it is unlikely that there would be adequate time to cure the deficiency.⁵⁹ Time is of the essence in the letter of credit transaction;⁶⁰ the customer sets an expiration date in order to protect his interest in receiving timely documentary presentment.⁶¹

B. *Substantial Compliance: Relaxation of the Compliance Standard*

The hypothetical seller's refuge would be in the standard of substantial compliance. This standard emerged in an attempt to promote equity to the beneficiary.⁶² It provides protection from "the unregenerate type—which tries to extricate itself from an unquestioned obligation by the kind of hypertechnical argument that has often tended to give the term 'banker' pejorative connotations."⁶³ In examining the documents, the

dishonor "is to be made, notice to that effect, stating the reasons therefore, must, without delay, be given by cable").

59. Some courts have held that estoppel may be invoked only if the beneficiary would have had sufficient time to cure the deficiency before the expiration of the credit. See *Colorado Nat'l Bank v. Board of County Comm'rs*, 634 P.2d 32, 41 (Colo. 1981) (en banc) ("The [beneficiary] could not have cured the defect since the presentment would have then been untimely. . . . Consequently, the [beneficiary] did not detrimentally rely on the Bank's failure to state as one ground for its dishonor of the drafts that the [beneficiary] presented demand instruments rather than fifteen-day sight drafts.") (citations omitted).

In *Crocker Commercial Servs., Inc. v. Countryside Bank*, 538 F. Supp. 1360 (N.D. Ill. 1981), the beneficiary presented documents shortly before the letter of credit was to expire and instructed the bank to inform it of any defects. See *id.* at 1361. U.C.C. § 5-112(1) (1977) provides that the bank be allowed three banking days to review documents to determine compliance. The bank notified the beneficiary of the discrepancy on the third day after presentment, but by that time the credit had expired. The court held that the documentary defects were "hypertechnical language difficulties" that were easily curable. See 538 F. Supp. at 1363. Accordingly, the bank was estopped from raising the defects as justification for nonpayment because it failed to give prompt notification of the apparent defects. See *id.* at 1363-64.

60. J. Dolan, *supra* note 1, ¶ 5.03[3][a], at 5-15; *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 872; see *Liberty Nat'l Bank & Trust Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 218 F.2d 831, 840-41 (10th Cir. 1955).

61. See J. Dolan, *supra* note 1, ¶ 5.03[3][e], at 5-20 to -21.

62. See *id.* ¶ 6.05[2], at 6-27 to -29 (impetus for the substantial compliance standard is the possibility that the beneficiary will lose the benefit of performance under his contract with the seller); J. White & R. Summers, *supra* note 2, § 18-6, at 729 ("Our primary concern here is with the rights of the *beneficiary* for wrongful dishonor.") (emphasis in original); Stoufflet, *Payment and Transfer in Documentary Letters of Credit: Interaction Between the French General Law of Obligations and the Uniform Customs and Practice*, 24 Ariz. L. Rev. 267, 270 (1982) ("Formalism provides certainty, but it is also blind to inequities. . . . It is not surprising that a party suffering as a result of formalistic rigor tries to evade its consequences by appealing to the general law of obligations.").

63. *Crocker Commercial Servs., Inc. v. Countryside Bank*, 538 F. Supp. 1360, 1362 (N.D. Ill. 1981).

bank is permitted to look beyond mere technical discrepancies,⁶⁴ so as to determine whether the presentment "complies" with the requirements of the letter of credit in *every material respect*.⁶⁵

Opponents of the standard are concerned that its application will lead to uncertainty in the letter of credit transaction, resulting in increased litigation and, possibly, an unwillingness on the part of banks to enter into letter of credit transactions.⁶⁶ The source of these fears is the blanket proposition that substantial compliance is sufficient.⁶⁷ An outright relaxation of the standard is likely to result in a greater number of beneficiary-litigants claiming compliance.⁶⁸ Furthermore, beneficiaries operating on the assumption that substantial compliance is sufficient may lose incentive to adhere closely to the terms of the credit. Consequently, customers are likely to challenge the bank's determination of compliance.⁶⁹ Although these fears are justified, they do not warrant a rejection of the rationale underlying the standard of substantial compliance. The solution lies in an approach that honors the traditional concerns underlying strict compliance and at the same time promotes equity with regard to the beneficiary.

C. *The Bifurcated Standard: The Anomalous Approach*

A middle ground could be found in the bifurcated standard,⁷⁰ which protects the issuer against suit by the customer for paying despite technical flaws in the documentary presentment.⁷¹ On the other hand, the issuer would be entitled to refuse payment by insisting on strict compliance from the beneficiary.⁷² This bifurcated standard results in an anomaly.

64. See *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F.2d 230, 237 (1st Cir. 1967) (court confessed to "semantic myopia" and looks beyond the technicalities), *cert. denied*, 390 U.S. 1013 (1968).

65. *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 699, 705 (1st Cir. 1978) (emphasis added).

66. See, e.g., *J. Dolan*, *supra* note 1, ¶ 6.02, at 6-4 to -6; *Judicial Development*, *supra* note 27, at 153; *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 855-56.

67. See *Judicial Development*, *supra* note 27, at 151-52.

68. See *Insurance Co. of N. Am. v. Heritage Bank*, 595 F.2d 171, 176 (3d Cir. 1979) (*per curiam*); *J. White & R. Summers*, *supra* note 2, § 18-6, at 729; *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 867.

69. See *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 868 ("court enforcement of issuer waiver of letter terms upon presentment is *per se* the enforcement, if not the creation, of a breach of the issuer-customer contract").

70. *B. Clark*, *supra* note 6, ¶ 8.5[4], at 8-48.

71. See *New York Study*, *supra* note 36, at 66-67, *reprinted in 1955 Report*, *supra* note 36, at 1634-35; *T. Quinn*, *supra* note 1, ¶ 5-114[A][8], at S5-23 (Cum. Supp. No. 2 1984); see also *Transamerica Delaval Inc. v. Citibank*, 545 F. Supp. 200, 203-04 (S.D.N.Y. 1982) (applying the bifurcated standard: beneficiary's demand, "while not literally or strictly in accordance with the language of the letter of credit, did substantially comply with the terms of the letter of credit such that Citibank's payment pursuant to that demand was reasonable and proper under the circumstances").

72. See *New York Study*, *supra* note 36, at 66, *reprinted in 1955 Report*, *supra* note 36, at 1634; *T. Quinn*, *supra* note 1, ¶ 5-114[A][8], at S5-23 (Cum. Supp. No. 2 1984); see

The bank's exercise of its discretionary power⁷³ is most needed by the beneficiary when the customer seeks to avoid payment by objecting to insubstantial discrepancies.⁷⁴ Yet this is also the time when the bank would least want to exercise its discretion to pay the beneficiary, because its customer may refuse reimbursement. Thus, under any of the three proposed standards, the purposes of the letter of credit are frustrated.

II. THE CONTRACTUAL NATURE OF THE ISSUER/BENEFICIARY RELATIONSHIP

The goals of the letter of credit can best be realized by reconciling the contractual notions of equity and substantiality with the need for certainty. This reconciliation can only be accomplished by recognizing the duties of the issuer to the beneficiary that arise by virtue of their relationship.

A. Basis for Contractual Characterization

Many courts and commentators discuss the three "contracts" that exist in the letter of credit transaction: buyer/seller, issuer/customer, and issuer/beneficiary.⁷⁵ Although the contractual characterization of the first two relationships is undisputed,⁷⁶ the description of the issuer/beneficiary relationship as a contract has been repeatedly attacked.⁷⁷ This denial of the contractual nature of the letter of credit has become the basis for many commentators' objections to the application of the notions of equity and substantiality.⁷⁸ The underlying fear is that the characterization of the issuer/beneficiary relationship as contractual will hinder the

also Far E. Textile, Ltd. v. City Nat'l Bank & Trust Co., 430 F. Supp. 193, 196-97 (S.D. Ohio 1977) (court applied bifurcated standard and insisted on strict compliance by the beneficiary).

73. New York Study, *supra* note 36, at 67, *reprinted in* 1955 Report, *supra* note 36, at 1635 (noting bank's exercise of discretion).

74. See *supra* notes 51-52 and accompanying text.

75. In classifying all three relationships as contractual, courts have noted that the issuer/beneficiary relationship is governed by traditional contract principles. See *Bank of N.C. v. Rock Island Bank*, 570 F.2d 202, 207 (7th Cir. 1978); *Venzelos, S.A. v. Chase Manhattan Bank*, 425 F.2d 461, 465-66 (2d Cir. 1970); *Data Gen. Corp. v. Citizens Nat'l Bank*, 502 F. Supp. 776, 784 (D. Conn. 1980); *West Va. Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1112 (W.D. Pa. 1976); *Dynamics Corp. v. Citizens & S. Nat'l Bank & Trust Co.*, 356 F. Supp. 991, 999 (N.D. Ga. 1973); *J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda) Ltd.*, 37 N.Y.2d 220, 225, 333 N.E.2d 168, 172, 371 N.Y.S.2d 892, 897, *cert. denied*, 423 U.S. 866 (1975); *Titanium Metals Corp. of Am. v. Space Metals, Inc.*, 529 P.2d 431, 433 (Utah 1974); 6 *Michie, supra* note 7, § 30, at 406; 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:15, at 258-59; see also U.C.C. § 5-116 official comment 3 (1977) (letter of credit should be "treated like any other contract").

76. See *B. Clark, supra* note 6, ¶ 8.2[1], at 8-6; *J. Dolan, supra* note 1, ¶ 2.08[1]-[2], at 2-15 to -16; *J. White & R. Summers, supra* note 2, § 18-2, at 711.

77. See, e.g., *J. White & R. Summers, supra* note 2, § 18-2, at 711-13; *A Solution to the Problem of Documentary Compliance, supra* note 7, at 860; *Current Theories and Usages, supra* note 23, at 589-92.

78. See *J. Dolan, supra* note 1, ¶ 2.02, at 2-3, ¶ 6.05, at 6-20; *A Solution to the Problem of Documentary Compliance, supra* note 7, at 859.

function of the letter of credit because it will lead to the demise of the strict compliance standard.⁷⁹ This fear is premised on the observation that courts tend to weaken the strict law of contract when they perceive the operation of that law as yielding unfair results.⁸⁰

Opponents of the contractual characterization first point to the intention of the drafters of the Code "to set an independent theoretical frame."⁸¹ The official comment to the Code plainly demonstrates, however, that the drafters were not attempting to define the issuer/beneficiary relationship, but rather to define the "limited scope" of Article Five in providing a basic framework for the tripartite structure of the letter of credit transaction.⁸² The comment to the specific provision regarding the issuer/beneficiary relationship states that "[t]he letter of credit is essentially a contract between the issuer and the beneficiary."⁸³ Thus, although the entire operation of the letter of credit falls within the "independent theoretical frame," the relationships of the parties are governed by basic contract principles.⁸⁴ "The letter of credit itself constitutes the contract between the issuing bank and the beneficiary of the credit, and the application, together with the letter of credit, constitutes the contract between the applicant [customer] and the issuing bank."⁸⁵

Some commentators have claimed that principles of contract law render impossible any working analogy of the letter of credit to a traditional contractual formula.⁸⁶ They have argued that the beneficiary has no contractual rights because there is no "meeting of the minds"⁸⁷ be-

79. See J. Dolan, *supra* note 1, ¶ 6.08, at 6-40 to -41.

80. *Id.* ¶ 6.02, at 6-3 to -4.

81. See J. White & R. Summers, *supra* note 2, § 18-2, at 711 (quoting U.C.C. § 5-101 official comment (1977)). Accordingly, some commentators have referred to the letter of credit as a "sui generis" legal obligation. See J. Dolan, *supra* note 1, ¶ 2.02, at 2-4; H. Harfield, *supra* note 4, at 53; A. Lowenfeld, *supra* note 8, § 5.52(c), at 144.

82. See U.C.C. § 5-101 official comment (1977).

83. U.C.C. § 5-114 official comment 1 (1977). The drafters of the Code repeatedly refer to the letter of credit as a contract. See, e.g., U.C.C. § 5-106 official comment 2 (1977) ("so far as the customer or beneficiary are concerned establishment of [a revocable] credit has no legal significance unless the parties provide otherwise in their contracts with the issuer"); *id.* § 5-116 official comment 3 (the letter of credit should be "treated like any other contract").

84. See *supra* note 75.

85. T. Quinn, *supra* note 1, ¶ 5-101[A][1][b], at 5-3.

86. See, e.g., J. Dolan, *supra* note 1, ¶ 2.02, at 2-3 to -4; J. White & R. Summers, *supra* note 2, § 18-2, at 711; Joseph, *supra* note 2, at 850-51; *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 857-59, 863; *Current Theories and Usages*, *supra* note 23, at 588-92.

87. The argument is that there is no meeting of the minds because the issuer and beneficiary do not enter into an "agreement" and because these parties are often unknown to each other. J. White & R. Summers, *supra* note 2, § 18-2, at 711; Joseph, *supra* note 2, at 850. Under the objective theory of contracts, however, "[a] contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent." J. Calamari & J. Perillo, *supra* note 8, § 2-2, at 23 (quoting *Hotchkiss v. National City Bank*, 200 F.

tween the issuer and the beneficiary and because no consideration has been provided by the beneficiary to the issuer,⁸⁸ and that the letter of credit beneficiary cannot properly be regarded as a third party beneficiary of the contract between the customer and the issuer.⁸⁹ These difficulties can be resolved by reference to the option contract.

B. *The Letter of Credit as an Option Contract*

The letter of credit can best be viewed as an option contract. An option contract is an irrevocable offer under which one party is bound to perform at the election of the other, who is not under any obligation.⁹⁰ When the bank issues a letter of credit it makes a promise to the beneficiary, which forms the basis of a contractual relationship. The bank's

287, 293 (S.D.N.Y. 1911) (L. Hand, J.), *aff'd sub nom.* Ernst v. Mechanics' & Metals Nat'l Bank, 201 F. 664 (2d Cir. 1912), *aff'd sub nom.* National City Bank v. Hotchkiss, 231 U.S. 50 (1913)). Thus, it is not necessary for the parties to be acquainted prior to entering into the contract. An offer can even be made to the public in general, provided that the terms are specific. See *id.* § 2-8, at 34-35.

The requisite "agreement" is present between the issuer and the beneficiary in the letter of credit transaction. See 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:4, at 231 (agreement is implied in fact from the terms of the credit and the beneficiary's conduct).

88. The argument is that the beneficiary supplies no consideration for the issuer's payment obligation. See B. Clark, *supra* note 6, ¶ 8.2[1], at 8-6; J. Dolan, *supra* note 1, ¶ 2.02, at 2-3; Joseph, *supra* note 2, at 850-51; *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 858 (quoting Kozolchyk I, *supra* note 51, at 135-36; *Current Theories and Usages*, *supra* note 23, at 589-90).

It is a settled principle of contract law, however, that consideration need not be supplied directly by the promisee; a third party may supply the consideration. See *Quattlebaum v. Gray*, 252 Ark. 610, 611-12, 480 S.W.2d 339, 340-41 (1972); *Cechettini v. Consumer Assocs.*, 260 Cal. App. 2d 295, 297, 67 Cal. Rptr. 15, 17 (1968); *City of Highland Park v. Grant-Mackenzie Co.*, 366 Mich. 430, 446-47, 115 N.W.2d 270, 278 (1962) (en banc); J. Calamari & J. Perillo, *supra* note 8, § 4-1, at 134 n.12.

In the letter of credit transaction, the customer, a third party, supplies consideration for the bank's irrevocable offer to the beneficiary. See Bartholomew, *Relations Between Banker and Seller Under Irrevocable Letters of Credit*, 5 McGill L.J. 89, 92 (1959); McCurdy, *Commercial Letters of Credit*, 35 Harv. L. Rev. 539, 575-76 (1922). See *infra* note 92 and accompanying text. Moreover, the consideration provided by the customer is sufficient to support both the bank's promise to its customer and its promise to the beneficiary. See J. Calamari & J. Perillo, *supra* note 8, § 4-22, at 173-74 ("[i]here is consideration for a set of promises if what is bargained for and given in exchange would have been consideration for each promise in the set if exchanged for that promise alone") (quoting Restatement (Second) of Contracts § 80(1) (1979)).

89. Although there are valid arguments against classifying the letter of credit as a third party beneficiary contract, see, e.g., J. White & R. Summers, *supra* note 2, § 18-2, at 714 (noting that the issuer/promisor in the letter of credit transaction, unlike the promisor in the third party beneficiary contract, cannot assert against the beneficiary defenses he could assert against the customer/promisee); Joseph, *supra* note 2, at 850-51 (same); *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 858-59 (same); *Current Theories and Usages*, *supra* note 23, at 590 (same), some courts have nevertheless adhered to such a characterization in defining the rights of the parties, see *West Va. Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1109-10 (W.D. Pa. 1976) (mem.); *Savage v. First Nat'l Bank & Trust Co.*, 413 F. Supp. 447, 451 (N.D. Okla. 1976); *Harvey Estes Constr. Co. v. Dry Dock Sav. Bank*, 381 F. Supp. 271, 274 (W.D. Okla. 1974).

90. J. Calamari & J. Perillo, *supra* note 8, § 4-15, at 158; see Restatement (Second) of Contracts § 25 (1979).

promise can be analyzed as an offer looking toward a unilateral contract. As with offers generally,⁹¹ it is only effective when received by the beneficiary.⁹² In the letter of credit the bank promises to pay if the beneficiary presents complying documents.⁹³ The bank requests not a return promise, but a return performance. By presenting complying documents the beneficiary accepts the offer and provides consideration for the bank's promise.⁹⁴ Time is of the essence because the offer cannot be accepted after it lapses.⁹⁵ The offer by the bank to the beneficiary is, of course, not just a revocable offer.⁹⁶ The customer has paid for it. That payment by the customer is consideration for the irrevocability feature of the offer.⁹⁷ In other words, when the bank issues a letter of credit in favor of a beneficiary, the bank makes an irrevocable offer looking to a unilateral contract. In effect, the beneficiary has an option contract. The bank is

91. E. Farnsworth, *Contracts* § 3.10, at 125 (1982).

92. U.C.C. § 5-106(1)(b) (1977).

93. See *Asociacion de Azucareros de Guatemala v. United States Nat'l Bank*, 423 F.2d 638, 641 (9th Cir. 1970); *Baker v. National Boulevard Bank*, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975); *Colorado Nat'l Bank v. Board of Comm'rs*, 634 P.2d 32, 36-37 (Colo. 1981) (en banc); *First Nat'l Bank v. Wynne*, 149 Ga. App. 811, 814, 256 S.E.2d 383, 385 (1979).

94. Performance by the offeree operates as acceptance of the option contract. See J. Calamari & J. Perillo, *supra* note 8, § 2-27, at 89; E. Farnsworth, *supra* note 91, § 8.2, at 541. Acceptance of the option contract constitutes consideration for the offeror's promise. See J. Calamari & J. Perillo, *supra* note 8, § 4-15, at 158.

95. See *supra* note 61 and accompanying text. Cf. J. Calamari & J. Perillo, *supra* note 8, § 2-27, at 91 (time is of the essence in the option contract).

96. Theoretically, the letter of credit may be revocable or irrevocable. U.C.C. § 5-103 official comment 1 (1977). It has been suggested, however, that the revocable letter of credit is an illusory contract. *West Va. Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1111 (W.D. Pa. 1976); see *A Solution to the Problem of Documentary Compliance*, *supra* note 7, at 848 n.1. Because they impose no true obligation on the issuer, revocable letters of credit have little commercial value. J. Dolan, *supra* note 1, ¶ 5.03[1], at 5-10; see A. Lowenfeld, *supra* note 8, at 130 n.i.

97. Article Five states that "[n]o consideration is necessary to establish a credit." U.C.C. § 5-105 (1977). The drafters did acknowledge, however, that consideration is actually provided for the bank's irrevocable offer by the customer, who pays a fee to the bank for issuing the letter of credit. See U.C.C. § 5-105 official comment (1977); 6 Michie, *supra* note 7, at 402. The reason for dispensing with the consideration requirement was merely to eliminate the potential burden to the beneficiary in ascertaining what an issuer has charged as a fee for issuing the credit. 3 R. Anderson, *Anderson on the Uniform Commercial Code* § 5-105:1 (2d ed. 1971); 6 Michie, *supra* note 7, § 28, at 402; T. Quinn, *supra* note 1, ¶ 5-105[A], at 5-18. Moreover, even in the absence of valid consideration, a statutory substitute for consideration would suffice to render the offer irrevocable. For example, the New York General Obligations Law provides that "when an offer to enter into a contract is made in a writing signed by the offeror . . . which states that the offer is irrevocable during a period set forth . . . , the offer shall not be revocable during such period . . . because of the absence of consideration for the assurance of irrevocability." N.Y. Gen. Oblig. Law § 5-1109 (McKinney 1978 & Supp. 1984-85); see J. Calamari & J. Perillo, *supra* note 8, § 2-27, at 89-90 & n.96; see also U.C.C. § 2-205 (1977) (no consideration needed for a firm offer by a merchant for the sale of goods). The letter of credit is a writing, signed by the issuer, see U.C.C. § 5-104(1)(1977), with clear language of irrevocability. E.g., J. Dolan, *supra* note 1, at A-61; H. Harfield, *supra* note 4, at 322.

bound to perform if the beneficiary performs,⁹⁸ but the beneficiary is not bound to present the documents.⁹⁹

Moreover, the beneficiary's documentary presentment not only constitutes acceptance of the issuer's offer and consideration for the issuer's promise, but also operates as an express condition precedent¹⁰⁰ to the issuer's payment obligation.¹⁰¹ Although the general rule is that express conditions require literal compliance,¹⁰² "there are situations in which the rule is not always rigidly adhered to."¹⁰³ A number of excuses have been carved out to protect the expectations of the parties.¹⁰⁴ Among them is the excuse of a condition where "the non-occurrence of [the] condition would cause disproportionate forfeiture, . . . [and] its occurrence was [not] a material part of the agreed exchange."¹⁰⁵

In the letter of credit transaction, because the bank's wrongful refusal to pay the draft results in forfeiture of the beneficiary's right to assured payment, the very purpose of the letter of credit is defeated.¹⁰⁶ The beneficiary will be compelled to sue the customer for breach of the underlying contract. Furthermore, the beneficiary cannot be supposed to have assumed the risk of forfeiture in the event of a slight technical discrepancy.¹⁰⁷ The beneficiary expects to receive payment against complying documents; he does not bargain for hypertechnical parsing of the docu-

98. J. Dolan, *supra* note 1, ¶ 2.01, at 2-2; 6 Michie, *supra* note 7, § 33(b), at 436.

99. "Although the letter of credit is a contract between banker and beneficiary, the beneficiary undertakes no duty of performance—if he chooses not to meet the conditions of the credit, he is not obligated to do so." H. Harfield, *supra* note 4, at 52; *see also* E. Farnsworth, *supra* note 91, § 8.2, at 541 (offeror is obliged to perform only if the offeree chooses to exercise the option).

100. 2 A. Squillante & J. Fonseca, *supra* note 1, §§ 7:15, at 261, 7:26, at 283. A condition is defined as "an act, or event, other than a lapse of time, which affects a duty to render a promised performance." J. Calamari & J. Perillo, *supra* note 8, § 11-1, at 383; *see* Restatement (Second) of Contracts § 224 (1979) ("an event, not certain to occur, which must occur, unless its non-occurrence is excused, before performance under a contract becomes due"). Unilateral contracts often involve express conditions. J. Calamari & J. Perillo, *supra* note 8, § 11-13; *see* E. Farnsworth, *supra* note 91, § 8.2, at 541 ("[I]f an offer has become an option contract . . . acceptance of that offer is a condition of the offeror's duty. The grantor of the option is bound although he will not have to perform if the option is not exercised."). Intention to render the offeror's duty conditional need not be expressed directly in writing; it may be manifested by the general nature of the agreement. *See* Restatement (Second) of Contracts § 226 comment a (1979).

101. *See supra* notes 99-100.

102. J. Calamari & J. Perillo, *supra* note 8, § 11-15, at 398; *see id.* § 2-27, at 91.

103. *Id.* § 11-15, at 398; *see* E. Farnsworth, *supra* note 91, § 8.3, at 545.

104. *See generally* J. Calamari & J. Perillo, *supra* note 8, §§ 11-31 to -41 (discussion of various excuses of conditions); E. Farnsworth, *supra* note 91, § 8.3, at 544 (same).

105. Restatement (Second) of Contracts § 229 comment c (1979); *see* E. Farnsworth, *supra* note 91, § 8.7.

106. *See supra* notes 2, 12-19 and accompanying text.

107. "In determining the nature of the event that is made a condition by the agreement, . . . it will not ordinarily be supposed that a party has assumed the risk of forfeiture. Where the language is doubtful, an interpretation is generally preferred that will avoid this risk." Restatement (Second) of Contracts § 227 comment c (1979).

ments.¹⁰⁸ Nor may it be supposed that the issuer and the customer entered into the transaction expecting to be relieved of their obligations because of technical discrepancies.¹⁰⁹

In addition to the threat of forfeiture, the court must consider the materiality of the discrepancy.¹¹⁰ Analogy to the contractual situations in which there is a condition of satisfaction¹¹¹ provides guidance in evaluating the beneficiary's documentary presentment. Parties often agree that the offeror's duty of performance is conditioned on his or a third party's satisfaction with the offeree's performance.¹¹² There are generally two types of satisfaction conditions: personal satisfaction, where evaluation of performance involves subjective elements of taste and fancy,¹¹³ and reasonable satisfaction, where suitability of performance is a matter of "mechanical fitness, utility, or marketability."¹¹⁴ The question of documentary compliance in the letter of credit situation falls squarely within the second category. While courts will generally defer to a party's determination of personal satisfaction, they recognize that the mechanical fitness condition imposes "a requirement [that], as a matter of law . . . the dissatisfaction be reasonable."¹¹⁵ Thus, the court is in a position to determine whether the beneficiary's performance is objectively satisfactory.¹¹⁶

The classification of the letter of credit as an option contract alleviates the problem of applying the vague notion of substantiality to the issuer/beneficiary relationship. The bank is required to determine whether there has been compliance with the conditions set by the credit. In this determination it must consider the possibility of excuse. In practice, the

108. Generally, the letter of credit states merely that drafts will be honored upon presentation of documents "in compliance" with the terms of the credit. See, e.g., J. Dolan, *supra* note 1, at A-61 (sample letter of credit); H. Harfield, *supra* note 4, at 322 (same).

109. See G. Gilmore & C. Black, *supra* note 16, at 121.

110. See *supra* note 105 and accompanying text.

111. Under a condition of satisfaction, a party's performance is conditioned upon his or a third party's satisfaction with the other contracting party's performance. J. Calamari & J. Perillo, *supra* note 8, § 11-16, at 398.

Although the letter of credit does not expressly provide that documents must be satisfactory to the bank, the bank's satisfaction is required by the nature of its obligation: The bank must determine whether or not documents comply with the terms of the credit. U.C.C. § 5-109(2) (1977); see 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:26, at 283 ("The important thing is if in the satisfaction of the issuer there is conformity in the goods as evidenced by the documents submitted in compliance with the terms of the credit then the issuer is duty bound to pay on that credit."). In addition, the bank may insert in its contract with the customer a satisfaction provision for specified documents. U.C.C. § 5-114(1) & official comment 1 (1977). But see *id.* (issuer may not require general satisfaction with all documents).

112. J. Calamari & J. Perillo, *supra* note 8, § 11-16, at 398.

113. *Id.* § 11-18, at 401-02.

114. *Id.*

115. *Id.* at 402.

116. See 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:26, at 284 (because documents are mechanical in nature, the degree of discretion is minimal).

bank can accomplish this task through the application of a modified version of the bifurcated standard.

III. THE BIFURCATED STANDARD AND THE CONTRACTUAL DUTY OF GOOD FAITH

A. *The Virtues of the Bifurcated Standard*

By requiring strict compliance between the issuer and the beneficiary but substantial compliance between the issuer and its customer,¹¹⁷ the bifurcated standard provides the bank with "some leeway for the exercise of honest judgment, especially in times of falling commodity prices when the bank may easily get into a cross-fire of pressures."¹¹⁸ This grant of discretionary power injects into the transaction the flexibility necessary to ensure the proper functioning of the letter of credit as a payment device:¹¹⁹ The bank need not dishonor a draft because of "microscopic discrepancies."¹²⁰ "Indeed, we may argue that a more satisfactory degree of 'certainty' is attained with flexible notions of fairness eliminating the need to circumvent the inflexible application of mechanical rules."¹²¹ In effect, application of the bifurcated standard should result in greater willingness on the part of the bank to honor the beneficiary's draft when it reasonably finds "apparent compliance"¹²² of the documents with the credit terms.

It is conceivable, however, that the bank might find itself in a position in which it is entitled to reimbursement from its customer, but actual reimbursement may be difficult or impossible to obtain.¹²³ In this situation, the bank is likely to exercise its discretion to promote its self-interest¹²⁴ by insisting on strict compliance from the beneficiary. To avoid this result, the traditional rule of strict compliance should be replaced by

117. See *supra* note 36 and accompanying text.

118. New York Study, *supra* note 36, at 66, *reprinted in* 1955 Report, *supra* note 36, at 1634; see T. Quinn, *supra* note 1, ¶ 5-114[A][8], at S5-22 to -23 (Cum. Supp. No. 2 1984).

119. T. Quinn, *supra* note 1, ¶ 5-114[A][8], at S5-23.

120. New York Study, *supra* note 36, at 66-67, *reprinted in* 1955 Report, *supra* note 36, at 1634-35.

121. Kessler & Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 Harv. L. Rev. 401, 449 (1964); see 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:17, at 263 (insistence on exact compliance "would bring credit commerce to a standstill").

122. U.C.C. § 5-114 official comment 1 (1977); see New York Study, *supra* note 36, at 67, *reprinted in* 1955 Report, *supra* note 36, at 1635 (bifurcated standard "recognizes that the conformity of a given document may be a matter of reasonable doubt. Where such doubt exists, the issuer is not made to act at his peril. . .").

123. See *supra* note 41 and accompanying text.

124. Such an exercise of discretion contravenes the purpose of the letter of credit. The issuer may not refuse payment of a draft merely because it fears that its customer will not satisfy its reimbursement obligation. 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:7, at 233; see *Baker v. National Boulevard Bank*, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975). One court, however, has suggested that payment under the credit may be enjoined once the customer has filed for bankruptcy. See *Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.)*, 1 Bankr. 284, 285-86 (D. Fla. 1979). Fortunately, this suggestion has

the law of conditions, applied in analogizing the letter of credit to an option contract. Thus, the modified bifurcated standard would retain substantial compliance as the standard in suits by the customer against the issuer, but would impose the law of conditions in suits by the beneficiary against the issuer. The bank would be required to determine whether documentary presentment is sufficient to justify excuse of literal compliance with the express condition. Moreover, the bank would be under a contractual duty to exercise in good faith the discretionary power granted under the bifurcated standard.¹²⁵

B. *The Contractual Duty to Exercise Good Faith*

There are two possible approaches to determining good faith. One is the "excluder" analysis propounded by Professor Robert S. Summers. This approach, rather than specifically defining good faith, focuses on types of conduct that involve bad faith.¹²⁶ Professor Summers includes in his "bad faith" classification the "abuse of a power to determine compliance."¹²⁷ The virtue of this approach is its emphasis on "faithfulness to an agreed common purpose and consistency with the justified expectations of the [parties]."¹²⁸ Professor Steven J. Burton suggests, however, that the vagueness of excluder analysis raises the possibility that courts might adhere to "felt requirements of morality,"¹²⁹ thereby imposing terms that may be incompatible with the parties' agreement.¹³⁰ In response, Professor Burton suggests a second approach—the so-called "cost perspective" theory.¹³¹ This approach asks two questions in determining whether the discretion-exercising promisor breached the contract by using its discretion in bad faith: "(1) At formation, what were the reasonably expected costs of performance (forgone opportunities) to the discretion-exercising promisor? (2) At performance, did the discretion-

been overlooked; such a practice "could wreak havoc" on the letter of credit transaction. Rutcofsky, *supra* note 7, at xxiii.

125. See Restatement (Second) of Contracts § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."); see also E. Farnsworth, *supra* note 91, § 7.17, at 527-28 ("[c]ourts have often supplied a term requiring a party to exercise good faith when that party has been given a discretionary power over one of the terms of the contract").

126. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195, 196, 233 (1968) [hereinafter cited as Summers I]; see Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 Cornell L. Rev. 810, 818 (1982) [hereinafter cited as Summers II]; see also Restatement (Second) Contracts § 205 comment d (1979) (noting bad faith classifications).

127. Summers I, *supra* note 126, at 232-33, 240-41.

128. Restatement (Second) Contracts § 205 comment a (1979); accord Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 Iowa L. Rev. 497, 498-99 (1984) [hereinafter cited as Burton I]; Summers II, *supra* note 126, at 821.

129. Burton I, *supra* note 128, at 499.

130. See *id.*

131. See *id.* at 504.

exercising promisor use its discretion to recapture an opportunity forgone on contracting?"¹³²

In contracting with its customer and issuing the letter of credit, the bank commits itself to honor complying drafts.¹³³ Aware of the risk of customer insolvency, the bank is likely to ascertain the customer's credit prior to entering into the contract.¹³⁴ Nevertheless, one of the "reasonably expected costs"¹³⁵ of the bank's performance is the risk that the customer will not satisfy its reimbursement obligation.¹³⁶ By issuing the letter of credit, the bank restricts its use of funds,¹³⁷ thereby foregoing other opportunities that might be more lucrative. If the bank chooses to dishonor the draft on a minor technicality, it eliminates the risk of not being reimbursed by the customer, thereby placing the funds at its disposal. It thus recaptures the foregone opportunity and will be deemed to have acted in bad faith.¹³⁸

In exercising its discretion, the bank must objectively examine the documents in comparison to the credit terms,¹³⁹ without regard to its relationship with its customer.¹⁴⁰ As long as the bank acts within reason, it will be protected under the bifurcated standard against the customer's claim for wrongful payment.¹⁴¹ Furthermore, the requirement under the modified bifurcated standard that the bank exercise its discretion in good

132. *Id.* at 506. Another good faith standard discussed by Professor Burton is the "contemplation standard," which asks two basic questions: "[W]hat was the discretion-exercising party's purpose in acting; and . . . was that purpose within the reasonable contemplation of the parties?" Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369, 386 (1980) [hereinafter cited as Burton II].

133. See *supra* note 7 and accompanying text.

134. See H. Harfield, *supra* note 4, at 34; 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:6, at 232.

135. Burton I, *supra* note 128, at 506.

136. See 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:7, at 233; see also *American Employers Ins. Co. v. Pioneer Bank & Trust Co.*, 538 F. Supp. 1354, 1359 (N.D. Ill. 1981) (mem.) (court held that customer's bankruptcy was irrelevant to the bank's duty to the beneficiary); *Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank*, 387 F. Supp. 92, 102-03 (M.D.N.C.) (issuer held liable to beneficiary despite customer's insolvency), *rev'd on other grounds*, 528 F.2d 802 (4th Cir. 1975); *Fair Pavilions, Inc. v. First Nat'l City Bank*, 19 N.Y.2d 512, 516, 227 N.E.2d 839, 840-41, 281 N.Y.S.2d 23, 25 (1967) (court notes that bank is improperly defending its own interest because it knows of its customer's insolvency).

137. Typically, the bank honors the beneficiary's draft with its own funds, not those of its customer. J. Dolan, *supra* note 1, ¶ 2.03, at 2-4; H. Harfield, *supra* note 4, at 15; see *In re M.J. Sales & Distrib. Co.*, 25 Bankr. 608, 614 (S.D.N.Y. 1982); *Boise Cascade Corp. v. First Sec. Bank*, 183 Mont. 378, 387-88, 600 P.2d 173, 179 (1979).

138. With regard to the exercise of discretion and satisfaction with performance, see *supra* notes 110-16 and accompanying text, Professor Burton notes that "if a party feigns dissatisfaction for other reasons, such as a falling market price, the discretion obviously is being exercised for a purpose not contemplated by the parties. A jury reasonably may infer that the party was recapturing a forgone opportunity." Burton II, *supra* note 132, at 401 (emphasis added).

139. See *supra* note 10 and accompanying text.

140. See *supra* note 10 and accompanying text.

141. New York Study, *supra* note 36, at 67, reprinted in 1955 Report, *supra* note 36, at 1635.

faith imposes no additional liability on the bank. There are two devices in common usage that will continue to provide protection to the paying bank. First, the bank, upon paying when there is a slight discrepancy, may request that the beneficiary provide an indemnity¹⁴² in the event that the discrepancy is ultimately determined to be material. In addition, the bank typically has a security interest in the merchandise that is the subject of the underlying buyer/seller contract.¹⁴³ Thus, the bank's appropriate recourse in the case of customer bankruptcy, for example, is not to deny payment because of a technical discrepancy, but rather to take possession of the goods in which it has a security interest.¹⁴⁴

CONCLUSION

Analogy of the letter of credit to an option contract provides the theoretical basis for contractual characterization of the issuer/beneficiary relationship. An application of the bifurcated standard that replaces the standard of strict compliance with the law of conditions in determining documentary compliance most effectively serves the purposes of the letter of credit. It alleviates the problems encountered by courts in attempting to apply the vague notion of substantiality and imposes on the bank a contractual duty to exercise discretion in good faith when determining compliance.

Arthur Fama, Jr.

142. U.C.C. § 5-113 (1977); J. Dolan, *supra* note 1, ¶ 6.06[1][b]; 6 Michie, *supra* note 7, at 425; 2 A. Squillante & J. Fonseca, *supra* note 1, § 7:23; see Dixon, Irmaos & Cia., Ltda. v. Chase Nat'l Bank, 144 F.2d 759, 762 (2d Cir. 1944) (noting the reasonableness and utility of indemnities in the letter of credit transaction), *cert. denied*, 324 U.S. 850 (1945); Megrah, *supra* note 23, at 257.

143. Generally, the customer's application for the credit provides, as one of the terms of the issuer/customer contract, that the issuer receive a security interest in the goods. See, e.g., J. Dolan, *supra* note 1, at A-83 (sample application); see *id.* ¶ 2.08[1], at 2-15; Rutcofsky, *supra* note 7, at xxiii.

144. 3 R. Anderson, *supra* note 97, § 5-114:11 to :13, at 420-21.

