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Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Goldsmiths in Lombard Street?)

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STANDBY LETTERS OF CREDIT AND FRAUD (IS THE STANDBY ONLY ANOTHER INVENTION OF THE GOLDSMITHS IN LOMBARD STREET?)*

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INTRODUCTION

The letter of credit is a commercial specialty. That is to say it comes to us from the law merchant and is a creature of merchants and bankers and not of lawyers. Consequently, the letter of credit does not fit well into the law of contract, where common law judges and lawyers are wont to put it. Being a specialty, the letter of credit needs the unique protection that the law merchant customarily has afforded to specialties. That protection consists above all of two features: (1) the principle that the specialty enjoys independence from related transactions that nonspecialties do not enjoy, and (2) the rule that specialties can command punctilious observance of their conditions. The first of these features of the law merchant is the independence principle; the second is the strict compliance rule.

This Article discusses a serious challenge in standby credit cases.[1] That challenge takes the form of an exception to the indepen-

* In his campaign against promissory notes, Lord Holt observed: "[T]he notes in question are only an invention of the goldsmiths in Lombard-Street, who had a mind to make a law to bind all those that did deal with them . . . ." Buller v. Crips, 87 Eng. Rep. 793, 793 (K.B. 1703).

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[1] The thesis of this Article (that the fraud exception must be limited narrowly in order to protect the standby) could well include the commercial letter of credit. In part because the commercial credit tends to be the subject of litigation in a relatively few centers of international trade and banking, and in part because the parties usually want commercial credits to be paid, the fraud defense does not pose as great a problem for commercial credits as for standby credits. The standby arises in virtually any executory contract setting. Courts and lawyers in all jurisdictions deal with it. Furthermore, when the beneficiary demands payment under a standby, his relationship with the account party has nearly always broken down. The account party that causes a commercial credit to issue usually wants the issuer to pay the beneficiary. The account party that causes a standby to issue usually does not want the issuer to pay the beneficiary. That latter account party resorts frequently to the fraud defense; the former does so infrequently. For an explanation of the differences between the standby and the commercial credit and a brief description of the roles the parties (account party, beneficiary, and issuer) play, see infra notes 4 and 5.

dence principle when there is "fraud in the transaction." This Article makes the point that the fraud exception must be a narrow one in order to avoid the destruction of the standby and that courts appear inclined to fashion a broad fraud exception that the specialty cannot withstand. Part I uses two common transactions to illustrate the need for the independence principle in the standby setting. Parts II through IV analyze the arguments in favor of a broad fraud defense. Those parts conclude that the arguments rest on a basic misunderstanding of the standby credit's functions and a misreading of section 5-114(2) of the Uniform Commercial Code ("UCC").[2] In particular, this Article demonstrates that the reference to "fraud in the transaction" in section 5-114(2) cannot be read to refer to the underlying transaction without radically altering the nature of standby credits, that scholarly commentary arguing the contrary draws on faulty analysis and unsupporting authority, and that courts should recognize only those fraud defenses that can be resolved quickly, that is, summarily.

Part V of the Article examines the history of three other merchant innovations: promissory notes, bills of lading, and extrinsic acceptances. This part explains that each of these innovations faced attempts by courts to force common law notions on them and that the courts substantially crippled all three, forcing the legislature to rescue the first two and causing the demise of the last. Part VI concludes that the standby faces a similar challenge and an uncertain future.

NATURE OF THE STANDBY

There are two standby transactions that arise with some frequency and that serve to illustrate the issues discussed here. The first involves the sale of goods by an American defense contractor to a large foreign buyer. The second involves a popular tax shelter structured as a limited partnership.

Defense Contractor Model[3]

Defense Contractor (Contractor) negotiates the sale of high technology optical equipment with Foreign Government (Buyer). During the negotiations, each party exercises its respective bargaining strength. They agree on the price ($22.5 million) but disagree on the method of payment. At one point, Contractor insists on a twenty percent downpayment, progress payments of an additional sixty percent

[2] Unless otherwise indicated, all references to the UCC are to the 1978 edition.

[3] This illustration is based on the facts of Itek Corp. v. First Nat'l Bank, 730 F.2d 19 (1st Cir. 1984).

during the course of performance, and the balance upon installation and satisfactory operation of the equipment. Buyer balks at these terms. It is concerned that Contractor may not perform at all or may perform unsatisfactorily. In these events Contractor will have Buyer's money, and Buyer will have a cause of action that it will have to pursue in a distant jurisdiction, Buyer being situated in one country, Contractor in another. Buyer is also concerned that its cause of action may become worthless in the face of Contractor's insolvency.

For a period of time the parties wrestle with the problem. Economically, Buyer is stronger than Contractor. However, Buyer recognizes that it is in Buyer's interest as well as Contractor's that Contractor have sufficient cash during the course of performance to pay raw material, manufacturing, and transportation costs. If Contractor cannot perform, Buyer will have to relet the contract, inevitably at higher cost and with inconvenient and costly delays in delivery. Buyer, therefore, agrees to make the downpayment and the progress payments but only if Contractor agrees to protect Buyer against the collection and litigation risks that those payments entail.

Contractor and Buyer are familiar with commercial letters of credit,[4] and they know that the commercial credit provides relative certainty and promptness of payment in a way that shifts the collection and litigation costs from the beneficiary of the commercial credit to the party on whose account the commercial credit is opened, the account party.[5] In the commercial-credit transaction the parties assume that the beneficiary will draw on the credit, but in the standby credit the parties trust that the contract will proceed without hitches and that the beneficiary will never have to draw. The beneficiary of a

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[4] Commercial letters of credit are common in the international sale of goods. Under the commercial credit, the buyer (account party) causes the credit to issue in favor of the seller (beneficiary). Traditionally, payment under the credit is conditioned on the seller's presentation of a draft, invoice, and shipping documents. See, e.g., Board of Trade v. Swiss Credit Bank, 728 F.2d 1241 (9th Cir. 1984); Banco Nacional De Desarrollo v. Mellon Bank, 726 F.2d 87 (3rd Cir. 1984); Ahmed v. National Bank of Pak., 572 F. Supp. 550 (S.D.N.Y. 1983).

[5] Note that in the commercial credit, the seller is the beneficiary. In the standby-credit model described in the text, the buyer is the beneficiary. See, e.g., Itek Corp. v. First Nat'l Bank, 730 F.2d 19, 20-21 (1st Cir. 1984); Rockwell Int'l Sys. v. Citibank, 719 F.2d 583, 584 (2d Cir. 1983); Wyle v. Bank Melli, 577 F. Supp. 1148, 1151 (N.D. Cal. 1983). Sometimes, in the commercial-sale context, the parties use a standby to protect a seller that delivers on open account and calls on the credit only if its invoices are not paid. See, e.g., Conoco, Inc. v. Norwest Bank Mason City, 767 F.2d 470, 470-71 (8th Cir. 1985); Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399, 401 (1st Cir. 1985); Philadelphia Gear Corp. v. FDIC, 751 F.2d 1131, 1133 (10th Cir. 1984), cert. granted, 54 U.S.L.W. 3270 (U.S. Oct. 22, 1985); Tosco Corp. v. FDIC, 723 F.2d 1242, 1244 (6th Cir. 1983); Roman Ceramics Corp. v. Peoples Nat'l Bank, 714 F.2d 1207, 1209 (3d Cir. 1983); Consolidated Aluminum Corp. v. Bank of Va., 704 F.2d 136, 137 (4th Cir. 1983).

standby is authorized to draw only if the account party fails to perform or performs unsatisfactorily.

In the defense contractor illustration, the parties agree that a strong financial institution, usually a foreign bank or the foreign subsidiary of a United States bank,[6] will issue two guaranties[7] in favor of Buyer, one to cover return of the downpayment, the other to cover return of the progress payments. Under those guaranties or guaranty letters, as they are sometimes called, the guaranty issuer will pay Buyer promptly and without inquiry upon Buyer's demand, provided that the demand is made in the time and manner specified in the guaranty.

The guaranty issuer insists that it have security for its guaranty, so the parties agree further that Contractor will cause a financially strong party (usually a commercial bank) to issue two standby credits in favor of the guaranty issuer. The first credit engages to pay the guaranty issuer a sum equal to the downpayment upon the guaranty issuer's order. The second engages to pay a sum equal to or less than the progress payments, as the guaranty issuer orders. If Buyer draws on a guaranty, the guaranty issuer will draw on the corresponding standby.

Contractor is concerned that there may be a draw on the credits when Contractor is not in default and asks that the credits contain conditions that protect against unauthorized drafts. Buyer refuses. It argues that any attempt to condition payment of the credit on the question of performance may force Buyer to litigate performance questions before payment and may force Buyer to litigate them in Contractor's forum. It is against these risks that Buyer is attempting to guard, and Buyer insists that the credits contain only paper conditions and that they be simple. The bank issues, then, two credits under which it engages to pay the guaranty issuer's drafts provided

6 Domestic banks generally do not issue guaranties. Under traditional banking notions, such secondary obligations are not the business of banking, to which banking activity is limited by statute or regulation. Arguably, banks do issue guaranties all of the time. They indorse negotiable instruments and they are explicitly authorized to issue certain indemnities. See, e.g., U.C.C. § 5-113; 12 C.F.R. § 7.7012 (1985). The Comptroller of the Currency has taken the position that national banks may guarantee a transaction in which it has a substantial interest. See Comptroller of the Currency, Staff Interpretive Letter No. 218, [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,299 (Sept. 16, 1981). As a matter of practice, however, domestic banks do not issue first demand guaranties, but foreign subsidiaries of domestic banks do. See 12 U.S.C. § 604(a) (1982); 12 C.F.R. §§ 7.7010(b), 347.3(c) (1985).

7 For a discussion of these guaranties, see International Chamber of Commerce, Uniform Rules for Contract Guarantees (1978); Wheble, "Problem Children"—Stand-By Letters of Credit and Simple First Demand Guarantees, 24 Ariz. L. Rev. 301 (1982); White, Bankers Guarantees and the Problem of Unfair Calling, 11 J. Mar. L. & Com. 121 (1979).

that they: (1) are presented prior to the respective credit's expiry; (2) bear a legend identifying the credit; and (3) are accompanied by a certificate reciting, in the downpayment credit, that the guaranty issuer paid on the downpayment guaranty, and in the performance credit, that the guaranty issuer paid on the progress-payments guaranty. Ultimately, Contractor will bear the cost of draws under the guaranties, for when Buyer draws on a guaranty, the guaranty issuer will draw on the standby; and in the event of draw under the standby, the bank issuer will seek reimbursement from Contractor.

There are alternatives to the course the parties have chosen. They could have used an escrow arrangement whereby an agent held the downpayment and progress payments. That alternative is unsatisfactory. It prevents Contractor from using the funds, and it fails to shift all the collection and litigation risks to Contractor, as Buyer insists. A truly independent escrow agent might refuse to pay Buyer in the event of a dispute over Contractor's performance. Thus, Buyer might have to litigate performance questions before it is paid—one of the risks Buyer wants to avoid.

The parties might have used a performance bond. A bond is a secondary obligation, and payment under a performance bond would be conditioned on the *fact* that Contractor has failed to perform. Once again, Buyer would face the very risk it wants to avoid—litigating the factual performance question while Contractor holds Buyer's money.

In short, the purpose of the standby is to effect a shifting of risks and the cost of bearing them from one party to another. Somebody must bear these costs. In the event of litigation over Contractor's performance, either Contractor or Buyer must litigate without the funds and perhaps in a distant and unfamiliar forum. If there is no standby credit, Buyer shoulders these risks. Under the standby arrangement Contractor bears them.

Limited Partnership Model[8]

Promoter, who may be a commercial real estate promoter, an oil and gas explorer, or any similar capital seeking venturer, is the general partner in a limited partnership that permits the limited partners to deduct depreciation and other losses experienced by the partnership on their personal income tax returns. Promoter knows that this

[8] This hypothetical is based on the facts of a number of recent cases. See Warner v. Central Trust Co., 715 F.2d 1121 (6th Cir. 1983); Cromwell v. Commerce & Energy Bank, 464 So. 2d 721 (La. 1985); Berry v. Bank of La., 439 So. 2d 1166 (La. Ct. App. 1983); GATX Leasing Corp. v. DBM Drilling Corp., 657 S.W.2d 178 (Tex. Ct. App. 1983).

vagary of the tax law enhances the attractiveness of his venture to investors when it is packaged with a standby credit. He will ask each Investor to put, say, $250,000 at risk (and thereby give Investor the possibility of $250,000 in deductions), but will only ask Investor to contribute $50,000 in cash. Investors' promissory notes will represent the balance; and standby credits, usually with Lending Bank as beneficiary,[9] will secure the notes. Promoter will use the secured notes to obtain a loan from Lending Bank and will use Investors' cash and the loan proceeds to construct condominiums or drill for oil. Lending Bank is willing to advance money against Investors' notes without investigating the creditworthiness of each Investor and without seeking traditional types of collateral from Investors, because Investors' notes are secured by the standby engagements of Investors' banks.[10] The standby arrangement, then, is attractive to all parties. The savings are not insubstantial. Investor wants a tax shelter; Promoter financing; and Lending Bank collateral. The standby helps satisfy each. First, because the standby arrangement only requires Investor to provide twenty percent of his investment in cash, he can leave the eighty percent balance in other income-producing assets. The standby actually contributes to Promoter's ability to finance his project, because Lending Bank values Investors' notes and lends against them at a relatively small discount. Lending Bank knows that they are backed by standby credits issued by commercial banks or other lending institutions and that, under the law of credits, Lending Bank as beneficiary does not need to evaluate the creditworthiness of each Investor-promisor. Each Investor's bank, the bank that issues the standby, must evaluate the creditworthiness of its customer in order to protect its right of reimbursement in the event of a draw under the standby; but the issuing bank usually knows Investor, who resides in its market and who is usually a depositor and valued customer. The efficiencies the standby yields make all parties more willing to partici-

9 Sometimes in tax shelter transactions the credits are issued directly to Lending Bank; sometimes to the partnership. In the former case, Lending Bank is the beneficiary and can draw directly on the issuer. In the latter case Lending Bank can draw on the issuer only if the credit is transferable. See U.C.C. § 5-116. In the event the credit is not transferable, Lending Bank may lose considerable protection. See infra Part V.

10 Investor's bank, of course, must as a matter of sound banking practice investigate the "bankability" of the "loan" it is making to the investor. See 12 C.F.R. § 7.7016 (1985) (standby letters of credit considered loans for determining if bank exceeded its lending limit); cf. 12 C.F.R. §§ 32.2(a), (d), 208.8(d)(1), 337.2(b) (1985) (regulations defining standby credits as loans). That investigation by Investors' banks, however, should be less expensive, in the aggregate, than the Lending Bank's investigation of each Investor would be. Investors may reside in many localities, but in each case the Investor's own banker knows something of his credit reputation and is on the spot to make further inquiries and evaluation.

pate. Promoter can market his investment opportunity through brokers and gain access to a wide market of potential investors, even though they reside outside Lending Bank's market and are strangers to Lending Bank.

If Investors can stop payment under the credit by obtaining an injunction against the issuing bank, all of these efficiencies diminish. First, and most importantly, Lending Bank values Investors' notes less than it does when payment is certain. Lending Bank may have to file multiple suits in distant fora. It insists, therefore, on discounting the notes heavily. Promoter must obtain more investors, dilute each Investor's shelter benefits, and reduce his potential profit. The investment is no longer attractive to Investor or to Lending Bank. Promoter may not be able to market the investment. Finally, an injunction has the effect of redistributing the risk from Investor to Lending Bank. If courts refuse to enter injunctions, Investors must select their options carefully. The Investors must determine whether Promoter and his investment scheme merit their trust and money. Courts that enter injunctions freely are allocating some of those investment costs to Lending Bank and its customers.

These model transactions illustrate the standby letter of credit as a commercial device that effects a transfer of risks from one party to an executory agreement to the other party of that agreement.[11] The standby does not always reduce costs; but it always transfers them from the beneficiary to the account party. If a court voids the standby, costs do not disappear; they are only transferred back to the beneficiary. That is, if the court voids the standby, it reallocates the litigation and forum costs (in the defense contractor illustration) or the credit evaluation and collection costs (in the tax shelter illustration).

[11] The illustrations in the text are two of the common uses of standby credits. Standby use has expanded dramatically and now extends to a large number of industries. Theoretically, the standby can arise in any transaction where performance or payment may be delayed. Recent cases illustrate the varied applications of standby credits. See, e.g., Paccar Int'l, Inc. v. Commercial Bank of Kuwait, 757 F.2d 1058 (9th Cir. 1985) (sale of trucks); Fustock v. ContiCommodity Servs., Inc., 610 F. Supp. 986 (S.D.N.Y. 1985) (silver futures contract); American Airlines, Inc. v. FDIC, 610 F. Supp. 199 (D. Kan. 1985) (equipment leases); Lombard-Wall, Inc. v. New York City Hous. Dev. Corp., No. 82-B-11556 (EJR) (S.D.N.Y. Apr. 4, 1985) (available Nov. 27, 1985, on LEXIS, Genfed library, Dist. file) (repurchase agreements); *In re* Glade Springs, Inc., 47 Bankr. 780 (Bankr. E.D. Tenn. 1985) (promissory note); see also authority cited supra note 5.

II. Rules for the New Idea

(Herein of the Independence Principle)

About twenty-five years ago when merchants[12] invented the standby, they assumed that the rules of the old commercial credit would apply to the new standby credit and, in particular, that the independence principle would protect the credit transaction (between the issuer and the beneficiary) from disputes arising out of the underlying transaction (the contract of sale or the tax shelter investment). That particular assumption is only natural since without the independence principle the standby does not work.

Generally, a letter of credit transaction is related to two separate transactions. The first is the underlying transaction. In the defense contractor illustration the underlying contract is the sales contract under which Buyer makes the downpayment and the progress payments. In the tax shelter illustration Investor's promissory note and his partnership agreement constitute the underlying transaction. The second related transaction is that between the account party and the issuing bank. This contract governs the obligation of Contractor to reimburse its bank when it pays Buyer under the standby and the obligation of Investor to reimburse his bank when it pays Lending Bank under the standby. The independence principle teaches that the bank's credit engagement is independent of these related arrangements.

If, for example, Buyer's standby is not independent of the underlying arrangement between Contractor and Buyer, Buyer will not have achieved the full shifting of risks it desires. If there is a dispute over Contractor's performance, Buyer will promptly draw on the guaranties, and the guaranty issuer will draw on the credits. At that point, Contractor may seek to stop payment. It will argue first that it is not in default. Given that fact, it will assert that there is no basis in the underlying contract or in the credit engagement for Buyer's draft. Often, Contractor will contend that the absence of its default in the underlying transaction renders Buyer's certificate false and its attempt to collect on the credit fraudulent.

Contractor's argument, however, begins with a fact that is entrenched in the underlying contract—that it is not in default. If it succeeds in delaying payment on that basis and forcing litigation of

[12] I use the term "merchant" in its broadest sense here to include bankers. Bankers are not merchants in a narrower, traditional sense, since bankers may not deal in goods. In this Article, I choose the term "merchant" over "businessman," in part to make the point that we are dealing here with the law merchant, much as the UCC anticipates. See U.C.C. §§ 1-102(2)(b), -103, 5-102(3) & comment 2.

that issue, it has succeeded in doing what the standby credit is designed to prevent it from doing. It has forced Buyer to litigate before Buyer effects a return of the payments, and it may force that litigation in its own forum. Contractor may not succeed, of course, in stopping payment permanently. It may only delay payment until the trier of fact resolves the factual disputes. To the extent that it is ultimately unsuccessful, Contractor will not destroy the feature of the credit that protects Buyer against Contractor's insolvency, but that feature of the credit is only part of the standby invention and is not its unique feature. A performance bond can achieve that protection for Buyer; but a performance bond, being a secondary obligation conditioned on Contractor's default, cannot effect a transfer of the litigation risks as the independent standby can. If Contractor, then, is successful in rendering the standby engagement subject to the underlying contract, it has transmuted the device from a new invention (the standby) into an old idea (the performance bond).[13] It is undeniable that Contractor's success reallocates the litigation risks. It does not reduce them, it moves them from Contractor (where the standby puts them) to Buyer (whom the standby is designed to protect). Contractor's lawsuit destroys the new idea.

Similarly, if the limited partnership's condominium project or oil-drilling venture is unsuccessful, the partnership will default on its loan, and Lending Bank will call Investors' notes. If Investors do not pay promptly, Lending Bank will make demand under the standby credits securing those notes. At that point, Investors may claim that the partnership and, perhaps, Lending Bank have defrauded them; and Investors will try to stop payment of the credits. If Investors are successful in stopping or delaying payment under the credits, Lending Bank may have to litigate, depending on the number and location of Investors, in multiple and distant fora and will have to do so without the funds. Investors' success in delaying payment destroys the benefit Lending Bank bargained for when it conditioned its loan to the partnership on the issuance of the standby credits.

The patent unfairness of risk reallocation that occurs when the account party delays or stops payment under the credit is all the more egregious by virtue of the fact that the delay or stoppage occurs after the account party has enjoyed the *ex ante* benefits of the standby. In

[13] There is nothing wrong with performance bonds, but they play a role different from the standby. They do not achieve prompt payment prior to the resolution of fact questions. The obligation of a bond issuer is secondary, and his liability is conditioned upon the indemnitee's showing of certain facts. It is precisely to avoid that showing and its attendant delays that the standby beneficiary asks for a standby instead of a bond. Banks, which issue most credits, moreover, are generally not authorized to issue bonds. See authority cited supra note 6.

the defense contractor example Buyer has made the downpayments and the progress payments assuming that it can effect their prompt return under the standby credits. Contractor has enjoyed the benefit of those payments, which, but for the Buyer's assumption that the standby credits were independent, it would not have made. By the same token, it is doubly unfair for Investor to delay or stop payment under the credit after Lending Bank has relied on it as an obligation of the issuer that is independent of the equities between Promoter and Investor. Significantly, Investor is not only trying to shift his litigation and forum costs to Lending Bank but is also shifting the risk of Promoter's fraud to Lending Bank.

The merchants' assumption, then, is unquestionably valid: the standby must be independent of the underlying transaction, or it does not work.

III. The Judicial Response

To a significant extent, many courts, bolstered by support from commentators, have told the merchants that they cannot have their new invention. Courts have not always delivered that prohibition explicitly. In fact, they are fond of reciting their allegiance to the independence principle. The gulf, however, between what they do and what they say is wide.

The critical deviation arises when the account party seeks an injunction to stop payment under the credit. In the defense contractor illustration Contractor agrees to the standby credit arrangement either because it is anxious to proceed with the sale and assumes that there will be no problems with its performance or because it does not appreciate the significance of the standby with its cost-of-litigation and forum-shifting features. In the limited partnership model Investors may be lulled into a false sense of security by Promoter's assurances that the partnership's investments will yield enough profit to repay the loans without resort to Investors' notes and the credits securing them, or Investors may not appreciate the significance of the standby. Defense Contractor has enjoyed the fruits of the credit, which was indispensable in bringing the parties together and facilitating the sale of the optical equipment. By the same token, Investors realized significant savings through their standby credits that prompted Lending Bank to make highly leveraged loans to the partnership.

When the transaction goes sour, however, Defense Contractor and Investors, having realized their benefits from the standby, want to deprive the beneficiaries of their standby benefits. Thus, when the parties to the defense contract become embroiled in disputes or the general partnership's investments fail to yield sufficient cash to service the bank's loan, the account parties try to stop payment. Their most effective weapon is the argument that there is fraud in the transaction.

There are many cases that deal with the fraud issue. A significant number of these, even some that ultimately rule in favor of the beneficiary, seriously hamper the effectiveness of the standby. The courts and some commentators rationalize these decisions in a number of ways, but the rationalizations do not withstand analysis.

IV. Sufficient and Insufficient Rationales for the Fraud Defense

The fraud defense has a measure of appeal. When it complains to the court that the beneficiary has practiced fraud in the underlying transaction or in the credit transaction, the account party gives the court pause. In the tax shelter illustration, for example, Investor will assert that Promoter has practiced fraud and that Lending Bank was party to, or should have known about, that fraud and should not be able to profit from it. The Defense Contractor will claim that Buyer has no right to a return of the downpayment or the progress payments and that the foreign bank should not have paid under the guaranties.

However appealing these fraud arguments may be, generally, they should not interrupt prompt completion of the credit transaction. When courts recognize any defense to the issuer's obligation under the credit to pay promptly the benefeciary's draft, they deprive the beneficiary of its bargain and tell the merchants that they cannot have their invention. Generally, courts have refused to ignore the fraud defense. A number of thoughtful decisions, however, have restricted the defense so that only *fraud in the credit transaction* justifies stopping payment;[14] that is, these courts limit the fraud defense to

[14] The defense of fraud in the transaction is often traced to a commercial-letter-of-credit case: Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). The case illustrates the point well because Justice Shientag, who wrote the opinion, clearly understood the problem. In *Sztejn* the court accepted as true for purposes of a motion to dismiss, the plaintiff's allegations that the account party had shipped rubbish in cartons and had presented a bill of lading to the issuer representing the cartons to contain bristles. The allegation, then, was that there was a fraudulent document in the credit transaction. Justice Shientag knew that any inquiry beyond the face of the documents posed a problem for the credit device:

> It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer, and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.

Id. at 721, 31 N.Y.S.2d at 633. He noted, however, that application of the independence princases where a party charges that the beneficiary is practicing fraud on the issuer.[15] Then, and only then, will these courts interrupt the standby transaction to investigate the fraud claim.

One cannot deny that that interruption diminishes the efficiency of the standby and constitutes judicial modification of the merchant's invention.[16] Because this narrow fraud-in-the-credit-transaction defense can operate within definite limits, however, it does not open the credit transaction to the plethora of disputes that can arise in related transactions and thus effects only modest changes in the standby device. By limiting itself to the credit transaction, this fraud defense restricts the inquiry narrowly. If a beneficiary presents forged or materially false documents to the issuing bank or if it presents documents it has stolen or obtained through fraudulent misconduct, courts will stop payment of the credit. Merchants can live with this modification of their invention. The modification is akin to the fraud-in-the-factum modification courts have fashioned for other commercial specialities[17] that are similar to the standby credit.[18]

ciple "presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit." Id., 31 N.Y.S.2d at 634. *Sztejn*, then, involved fraud in the the credit transaction itself.

[15] Some courts have given the term "fraud" an even narrower reading. In United City Merchants (Inv.) Ltd. v. Royal Bank of Can., [1982] 2 W.L.R. 1039 (H.L.), for example, the court forced an issuer to pay against a bill of lading that stated falsely that the goods were on board prior to the final date for loading permitted by the credit. Because loading brokers had made the false statement not at the behest of the beneficiary and without the beneficiary's knowledge, the court saw the fraud as insufficient to stop payment. For criticism of the *United City* case on this narrow point, see Smith, Irrevocable Letters of Credit and Third Party Fraud: The *American Accord*, 24 Va. J. Int'l L. 55 (1983). For a general discussion of the fraud rule in foreign jurisdictions, see H. Gutteridge & M. Megrah, The Law of Bankers' Commercial Credits 137-45 (6th ed. 1979); B. Kozolchyk, Commercial Letters of Credit in the Americas 295-308 (1966); Ellinger, Fraud in Documentary Credit Transactions, 1981 J. Bus. L. 258.

[16] The *United City* court explained its reluctance to observe a broad fraud rule: It would "destroy the autonomy of the documentary credit which is its raison d'etre." [1982] 2 W.L.R. at 1047 (H.L.).

[17] See U.C.C. § 3-305(2); cf. Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077, 1082 (6th Cir. 1977) (attempting to engraft "fraud-in-factum" notion to letter-of-credit law); Werner v. A.L. Grootemaat & Sons, 80 Wis. 2d 513, 523, 259 N.W.2d 310, 315 (1977) (same). A fraud-in-the-factum defense requires the court to look into the underlying transaction and therefore does not satisfy the criticism of this Article that such an inquiry destroys the credit.

[18] The value of the distinction in the law of negotiable instruments between defenses that are good against the holder in due course and those that are not lies in the fact that common, commercial defenses are eliminated and the unusual, egregious defenses are retained. In commercial sales the most common defenses are failure of consideration, i.e., breach of warranty, and fraud in the inducement (usually nothing more than a higher degree of warranty breach). Negotiable-instruments rules take those defenses away from the obligor because if he were to keep them, negotiable instruments would not work. By the same token, letter-of-credit law should take away from the issuer and the account party those defenses that will prevent the

In all events the fraud exception must be a narrow one. This Article proposes that while fraud in the credit transaction should generally justify the issuer's dishonor, only fraud that courts can determine quickly and does not involve the underlying transaction should constitute a defense. If the account party alleges that the beneficiary has forged a certificate of default or has fabricated invoices and presented such documents to the issuer to obtain payment, the courts can inquire without doing egregious damage to the credit device. When the account party alleges, however, that the assertion in a certificate is false or that the invoices cover merchandise that does not comply with the underlying contract, he is inviting the court into the underlying contract. The court that accepts that invitation is endangering the credit device. Sometimes it may be difficult for the court to know at the hearing on the request for a temporary restraining order whether the account party is bringing the underlying dispute into the credit transaction. Often, however, the attempt is patent as it is in the defense contractor and tax shelter examples. At the latest, the court will know when the account party presents his evidence at the hearing on the preliminary injunction.

There is a significant body of case law that extends the fraud defense substantially beyond the credit transaction, broadens the inquiry to include commercial disputes, and alters the credit device to the point that it becomes the equivalent of a performance bond. Courts that fashion this rule usually offer justification for their departure from the independence principle, but the justifications are unpersuasive; and, in a disconcertingly large number of cases, the courts make a perfunctory bow to the independence principle and then ignore it with abandon.

Recently, for example, the United States Court of Appeals for the First Circuit considered a standby credit transaction on which the defense contractor illustration is modeled.[19] Early in the fraud inquiry the opinion acknowledged that an expansive fraud defense would wreck an important function of the credit: "[T]o make certain that contractual disputes wend their way towards resolution with money in the beneficiary's pocket rather than in the pocket of the [account] party."[20] The opinion further recognized that by launching an inquiry into the underlying transaction, the court "risks depriving [the] beneficiary of the very advantage for which he bargained,

credit from working. In neither case are we concerned with the defenses per se. We are concerned with their commercial effects.

19 Itek Corp. v. First Nat'l Bank, 730 F.2d 19 (1st Cir. 1984).

20 Id. at 24.

namely that the dispute would be resolved while he is in possession of the money."[21] In short, the court knew the reason for the independence principle and knew that adherence to the principle was indispensable to achieve at least one objective of the credit. The court went on to say that courts must invoke the fraud exception to the independence principle carefully and that the court should be mindful of the "parties' original allocation of risks and responsibilities."[22]

This language might lull the reader into a sense that the court understood the merchants' invention and intended to protect it; but after constructing this frame for standby credit litigation, the court swept it away. The beneficiary could legitimately call the standby credit, the court held, only if Buyer had legitimately called the guaranty letter. Whether Buyer had the right to call the guaranty letter, the court continued, depended on the terms of the underlying sales contract.[23] Thus, the court paid only lip service to the notion that the credit was independent of the underlying contract. In fact, the court held that it was dependent. The court said that the beneficiary should not be deprived of its bargain, and then did so. The litigation, ostensibly over the beneficiary's rights under a letter of credit, became a lawsuit on the underlying contract in which the court interpreted the sales contract's force majeure clause and additional terms (e.g., "causal," "on his opinion," "clearance") and drew inferences from the parties' course of performance.

The opinion does not acknowledge this inconsistency, but the flavor of the opinion supports the conclusion that, consciously or unconsciously, the court thought it proper to disregard the independence principle in order to promote a fair result. It appeals to one's sense of justice to say, as the court did, that a beneficiary who draws on a credit knowing that the obligations the credit secures have been performed is making a fraudulent draw and should be stopped.[24] At

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21 Id. (citations omitted).

22 Id. at 25.

23 We conclude that the issue before us is whether, given the terms of the contract, the Ministry and in turn Melli have a colorable right to call the "guarantees," or whether Itek has successfully shown that, in light of the contractual terms governing the guarantees, the beneficiaries' demands for payment have "absolutely no basis in fact."

Id. at 25 (quoting Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 999 (N.D. Ga. 1973)).

24 Thus, in Bank of Newport v. First Nat'l Bank & Trust Co., 687 F.2d 1257, 1261 (8th Cir. 1982), the court decided that since "no innocent third parties [were] involved," it was proper to litigate the fraud questions in a suit for wrongful dishonor of the credit engagement. Other recent cases indicate that courts are frequently disposed to litigate underlying fraud in the credit context and do not see that disposition as a serious problem for credits. In Rockwell Int'l Sys. v. Citibank, 719 F.2d 583 (2d Cir. 1983), the account party claimed that it had the

what point, however, did the court know that the obligations had been performed and that the beneficiary knew they had been performed? Only after the court construed the underlying contract's terms, examined the history of performance, and resolved the conflicting arguments of the parties did it know whether there was fraud. The rule defined by the court compels that inquiry;[25] and sometimes

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right to invoke the force majeure clause of the underlying contract and, therefore, the beneficiary's draw under the standby credit was fraudulent. Id. at 585. The court willingly entertained the claim even though the inquiry into fraud involved matters extrinsic to the credit transaction. In fact, the court found that there was fraud, and it reached that conclusion in part from its review of the Iranian conduct not in this credit transaction or in the related underlying contract, but in unrelated lawsuits. Id. at 588-89. In Sperry Int'l Trade, Inc. v. Government of Isr., 689 F.2d 301 (2d Cir. 1982), the Second Circuit held (properly, it would seem, as a matter of arbitration law) that it could not upset the order of a panel of arbitrators that a credit issuer pay the credit proceeds into an escrow account, pending arbitration of the account party's contract dispute with the beneficiary. Thus the beneficiary, having bargained for a standby letter of credit so that it would have the funds during the arbitration, had to arbitrate with the funds in an escrow account. Id. at 303 n.2. If the beneficiary had wanted an escrow arrangement, it could have bargained for one. In Roman Ceramics Corp. v. Peoples Nat'l Bank, 714 F.2d 1207 (3d Cir. 1983), the account party disputed the assertion in the beneficiary's certificate that an invoice was unpaid. The credit, an invoice standby credit, was payable against that certificate. Id. at 1209-10. The court concluded that if the certificate were false there was fraud in the transaction, and payment should be enjoined. Id. at 1216. The trouble with that holding is that in order to determine whether the invoice was paid, the court had to hear a trial of the parties' disputes on the underlying contracts. In many of these cases, *Rockwell* being an exception, courts fail to make it clear why the account party cannot litigate with the beneficiary in the beneficiary's forum after payment. For similar recent cases, see Paccar Int'l, Inc. v. Commercial Bank of Kuwait, 587 F. Supp. 783 (C.D. Cal. 1984), rev'd on other grounds, 757 F.2d 1058 (9th Cir. 1985); American Nat'l Bank & Trust Co. v. Hamilton Indus. Int'l, 583 F. Supp. 164 (N.D. Ill. 1984), rev'd sub nom. Banque Paribas v. Hamilton Indus. Int'l, 767 F.2d 380 (7th Cir. 1985); Universal Marine Ins. Co. v. Beacon Ins. Co., 581 F. Supp. 1131 (W.D.N.C. 1984); Banco Continental v. First Nat'l Bank, 100 F.R.D. 426 (E.D. Tenn. 1983); Griffin Cos. v. First Nat'l Bank, 374 N.W.2d 768 (Minn. Ct. App. 1985). But cf. Enterprise Int'l, Inc., v. Corporacion Estatal Petrolera Ecuatoriana, 762 F.2d 464 (5th Cir. 1985) (American account party's alleged difficulties in suing beneficiary, Ecuadorian state agency, insufficient to show inadequate remedy at law).

25 There have been attempts to limit the havoc wreaked by the fraud inquiry. Some cases follow the rule of Intraworld Indus. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316 (1975), and Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973). Those cases hold that inquiry in the letter-of-credit litigation should not expand into a full-blown trial on the merits of the underlying dispute. The inquiry should be preliminary and should only decide whether there is any basis in fact for the beneficiary's claim under the credit. See infra text accompanying notes 33-37. Symons argues that, contrary to language in the opinions about "egregious" or gross fraud, the courts should, and do enjoin payment applying an "intentional" fraud standard. Symons, Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief, 54 Tul. L. Rev. 338, 339 (1980). These efforts at limiting the fraud inquiry recognize *a priori* that the fraud inquiry has unfortunate consequences for the credit device. Unfortunately, these efforts fail. In the *Intraworld* case, for example, Mrs. Cymbalista, the Swiss beneficiary of a standby credit, had to wait nearly eleven months for her money and had to litigate in both the trial court and Supreme Court of Pennsylvania. Originally the parties had negotiated for a performance bond to guarantee the lease payment in question. 461 Pa. at 348, 336 A.2d at 318-19. Later they renegotiated and agreed to a standby letter of

at the close of the inquiry the court may decide that there is no fraud. By then it is too late to protect the beneficiary, who has lost his bargain, and too late to protect the credit, which is no longer a unique device but only another kind of bond. Even if the court finds at the end of that inquiry that there is fraud, the process has occurred in a forum and under circumstances contrary to the bargain the parties struck. In addition, the account party, after enjoying the fruits of the credit *ex ante*, has avoided the cost of litigating without the funds in the beneficiary's forum.

Uniform Commercial Code Section 5-114(2)

Some commentators and courts contend that fraud in the underlying transaction is one kind of fraud that justifies stopping payment.[26] Some argue, furthermore, that the drafting history of section 5-114(2)[27] of the UCC supports the view that fraud in the underlying

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credit, id., 336 A.2d at 319, but the court, by virtue of the delay and fraud litigation, rendered the standby a performance bond. In Roman Ceramics Corp. v. Peoples Nat'l Bank, 714 F.2d 1207 (3d Cir. 1983), the court followed the *Intraworld* test and found that there was indeed fraud, id. at 1212-13, but Judge Adams in dissent pointed out that the trial court "was able to find fraud only after it had reviewed facts developed at an extensive trial and had answered some difficult questions of law," id. at 1218 (Adams, J., dissenting).

26 Commentators taking that position include respected authorities. See Ellinger, supra note 15; Megrah, Risk Aspects of the Irrevocable Documentary Credit, 24 Ariz. L. Rev. 255 (1982); McLaughlin, Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy, 43 Ohio St. L.J. 1 (1982); Symons, supra note 25. There are also many opinions saying that fraud in the underlying transaction supports an injunction against payment. E.g., Itek Corp. v. First Nat'l Bank, 730 F.2d 19, 23-24 (1st Cir. 1984); Rockwell Int'l Sys. v. Citibank, 719 F.2d 583, 589 (2d Cir. 1983); Harris Corp. v. National Iranian Radio & Television, 691 F.2d 1344, 1354-55 (11th Cir. 1982). There is, however, commentary arguing that the only fraud that justifies an injunction must be fraud in the credit transaction. Geva, Contractual Defenses As Claims to the Instrument: The Right to Block Payment On a Banker's Instrument, 58 Or. L. Rev. 283 (1979); Harfield, Enjoining Letter of Credit Transactions, 95 Banking L.J. 596 (1978); Justice, Letters of Credit: Expectations and Frustrations (pts. 1 & 2), 94 Banking L.J. 424, 493 (1977); cf. West Virginia Hous. Dev. Fund v. Sroka, 415 F. Supp. 1107, 1114 (W.D. Pa. 1976) (restricting fraud inquiry to the credit transaction); Jupiter Orrington Corp. v. Zweifel, 127 Ill. App. 3d 559, 469 N.E.2d 590 (1984) (denying injunction in the face of an argument that assertions about underlying transaction in a certificate were untrue); Cromwell v. Commerce & Energy Bank, 450 So. 2d 1 (La. Ct. App. 1984) (same), aff'd in part, rev'd in part, 464 So. 2d 721 (1985); Mid-States Mortgage Corp. v. National Bank, 77 Mich. App. 651, 259 N.W.2d 175 (1977) (same); Chiat/Day Inc. v. Kalimian, 105 A.D.2d 94, 483 N.Y.S.2d 235 (1984) (refusing to enjoin draw on credit when dispute was over underlying lease). Much of the language in the cases is confusing. The facts do not always show the kind of fraud the court defines and many of the assertions may be dicta. See generally, J. Dolan, The Law of Letters of Credit ¶ 7.04[3][b] (1984) (examining and finding equivocal support for proposition that "fraud in the transaction" language refers to underlying transaction).

27 It is the general rule of § 5-114(2) that the issuer, absent a court order, *must* honor the beneficiary's draft or demand for payment "when documents appear on their face to comply with the terms of a credit." U.C.C. § 5-114(2). That rule loses its compulsory quality, however, if "a required document does not in fact conform to the warranties made on negotiation

transaction is an adequate ground to stop payment. The latter argument rests on an unwarranted assumption.

The assumption is that the addition of the words "or there is fraud in the transaction" during the drafting of the section was an attempt to include fraud extrinsic to the documents within the list of fraudulent practices that would justify dishonor of the credit. The argument rests on the idea that the earlier version of section 5-114(2), in describing the instances of fraud that justify stopping payment, had listed all possible instances of fraud in the credit transaction. Thus, some concluded incorrectly that the drafters must have meant to include fraud in the underlying transaction as justification for stopping payment. That conclusion is incorrect for three reasons. First, and most important, the early draft of the provision did not cover all fraud in the credit transaction. It missed the fraudulent practice of presenting nonforged, nonfraudulent documents that did not breach any Article 7 or Article 8 warranties but that the beneficiary obtained by fraud.[28] The additional language covers nondocumentary fraud in the credit transaction.

Second, if the drafters had intended the additional language to cover fraud in the underlying transaction, it would have made sense for them to refer specifically to the underlying transaction rather than to "the transaction." In section 5-114(1), the drafters do refer to the underlying transaction. Their choice of words is revealing. The drafters call the underlying transaction "the underlying contract for sale or other contract between the customer and the beneficiary." The reference in subsection (2) to "the transaction" is much more likely a reference to the *credit* transaction that the drafters were talk-

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or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent *or there is fraud in the transaction*." Id. (emphasis added). See Griffin Cos. v. First Nat'l Bank, 374 N.W.2d 768, 771 (Minn. Ct. App. 1985). Prior to 1957, the rule requiring the issuer to pay the beneficiary and the exceptions to the rule appeared in § 5-111. That section authorized a court to enjoin payment if there was "forgery or fraud in a required document." U.C.C. § 5-111(1) (1952). In 1956 the editorial board, in response to various studies, including the extensive study sponsored by the New York Law Revision Commission, recommended significant changes in the official text of the Code. Among them was a complete revision of the duty-to-pay provision which was to become § 5-114(2). See American Law Institute, 1956 Recommendations of the Editorial Board for the Uniform Commercial Code § 5-114(2) (1957), reprinted in 18 E. Kelly, Uniform Commercial Code Drafts 180 (1984) [hereinafter cited as 1956 Recommendations].

28 Scarsdale Nat'l Bank & Trust Co. v. Toronto-Dominion Bank, 533 F. Supp. 378 (S.D.N.Y. 1982) illustrates this type of fraud. The credit in *Scarsdale* called for a certificate executed by the account party. Id. at 379-80. The beneficiary fraudulently obtained the certificate, which did not violate Article 7 or 8 warranties, was not forged, and was not fraudulent. Id. at 385. The fraud consisted of the beneficiary's obtaining the certificate without authority. Id. at 386-87, 388 n.15. There was clear fraud in the credit transaction, but it was covered by § 5-114(2) only under the language "fraud in the transaction."

ing about earlier in the sentence, i.e., the transaction involving the documents of title, securities and other "required" documents. Those documents arise in the *credit* transaction.

Third, if the reference in section 5-114(2) to "fraud in the transaction" refers to fraud in the underlying transaction, the drafters have untethered the fraud inquiry and exposed the credit to the kind of treatment it received at the hands of the First Circuit in the defense contractor case. It could be that the drafters were unmindful of the consequences of that drafting change, but their apparent decision to eschew the word "underlying" or some similar modifier of the word "transaction" and their solicitude elsewhere in Article 5 (including one instance in section 5-114 itself) for the independence principle, militate against that conclusion. In short, if the language that the drafters added to section 5-114(2) encompasses fraud in the underlying transaction, the drafters have worked a revolutionary change in credit law. As this Article has demonstrated, if the account party can force the beneficiary to litigate the fraud issue in the account party's forum before payment, the account party has destroyed two essential features of the credit. The fraud-in-the-underlying-transaction argument permits the account party to effect that destruction in a significant number of cases.[29]

Some commentators make this invalid assumption concerning the drafting history of section 5-114(2) and cite as support the New

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[29] This Article does not discuss the prerequisites that equity has fashioned for injunctions. The injunction is the favorite remedy of account parties who want to stop payment under the credit. They frequently fail to obtain an injunction because they cannot satisfy the prerequisites, especially the need to show the absence of an adequate remedy at law. See, e.g., Enterprise Int'l, Inc. v. Corporacion Estatal Petrolera Ecuatoriana, 762 F.2d 464, 472-74 (5th Cir. 1985); Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 239-40 (5th Cir. 1983); Sperry Int'l Trade, Inc. v. Government of Isr., 670 F.2d 8, 11-12 (2d Cir. 1982). While that principle of equity contains the damage to credits that injunctions can wreak, the need remains to fashion the fraud rule narrowly. Many courts are willing to find that the account party has demonstrated an inadequate remedy. E.g., Itek Corp. v. First Nat'l Bank, 730 F.2d 19, 22-23 (1st Cir. 1984); Wyle v. Bank Melli, 577 F. Supp. 1148, 1163-65 (N.D. Cal. 1983).

In an extraordinary dictum, Judge Breyer, who wrote the *Itek* opinion, cast a serious cloud on the First Circuit's requirement that the account party demonstrate an inadequate remedy at law before it can have an injunction against payment of a credit. In Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399 (1st Cir. 1985), the account party of a standby credit had not obtained an injunction but sued the beneficiary, a commercial bank, for obtaining payment fraudulently. The district court entered judgment on a verdict for the amount of the credit ($139,700) plus punitive damages of $1,397,000. Id. at 403. Clearly, this account party had an adequate remedy at law. Yet, in the opinion affirming that judgment, Judge Breyer asserted, almost parenthetically, that the case was one in which an injunction should have issued. 757 F.2d at 404. The assertion is surprising in view of Judge Breyer's holding in *Itek* that there should be no injunction if the account party has an adequate remedy at law.

York Law Revision Commission's important study of the Code.[30] That study appeared just before the code drafters inserted the words "fraud in the transaction" in section 5-114(2), but there is nothing in the study to support that claim. The portions usually cited do not relate to the fraud question but to extraordinary circumstances that the study's author, Professor Rudolph Schlesinger, thought should be covered. None of the circumstances involve fraud.[31]

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30 Much of the confusion stems from two student papers: Note, "Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution, 93 Harv. L. Rev. 992 (1980); Comment, Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases, 21 Harv. Int'l L.J. 189 (1980). Frequently, courts and commentators cite these papers as authority for the proposition that § 5-114(2) and its drafting history support the notion that fraud in the underlying transaction is grounds for an injunction against payment of the credit. Larson v. First Interstate Bank, 603 F. Supp. 467, 469 n.1 (D. Ariz. 1983); Wyle v. Bank Melli, 577 F. Supp. 1148, 1163 (N.D. Cal. 1983); Verner, "Fraud in the Transaction": *Intraworld* Comes of Age in *Itek*, 14 Mem. St. U.L. Rev. 153, 159, 162 (1984). For a discussion of those student papers, see infra note 31.

31 Rudolf Schlesinger, then a professor at Cornell Law School, prepared the study of article 5 for the New York Law Revision Commission. See 3 N.Y.L. Rev'n Comm'n Report, Study of the Uniform Commercial Code 1575 (1955). In it, he complained that the 1952 version of the fraud rule was ambiguous because it did not make clear whether the provision was meant to overturn prior case law that he thought covered "extraordinary circumstances short of fraud or forgery" in a required document. Id. at 1658. The extraordinary circumstances he mentioned ((1) insolvency of the account party or the issuer, (2) conditions of war, or (3) local government activity that rendered relief in the account party's jurisdiction inadequate) do not involve fraud at all. They are circumstances that relate to the justifications for injunctions as a matter of equity, not as a matter of letter-of-credit law. Id. at 1657. The 1956 version clearly does not address Professor Schlesinger's concern, since it refers only to problems with the documents and "fraud in the transaction." The final report of the Law Revision Commission makes Professor Schlesinger's point clearly:

> (S)ection 5-111(1) provides that in the event of forgery or fraud in required documents, a court of appropriate jurisdiction may enjoin the issuing or confirming bank from honoring or reimbursing, but contains no provision as to whether there may be circumstances *short of fraud or forgery* in which injunctive relief is proper.

N.Y.L. Rev'n Comm'n, Report Relating to the Uniform Commercial Code 46 (1956). Two student commentators in oft-cited papers draw a different conclusion. One argues that the addition of the words "fraud in the transaction" must include "some basic notion that there could be both fraud in a required document and some other sort of fraud external to the documents." Comment, supra note 30, at 205 n.85; see also Kimball & Sanders, Preventing Wrongful Payment of Guaranty Letters of Credit—Lessons From Iran, 39 Bus. Law. 417, 424 (1984) (arguing that the narrow reading of § 5-114(2) "seems to render the phrase redundant"). The second student work concludes from the drafting history that the "beneficiary's misperformance of the underlying contract alone could provide grounds for injunctive relief." Note, supra note 30, at 1006; see also, Symons, supra note 25, at 368 (arguing that fraud in the underlying transaction usually cannot be distinguished from fraud in the credit transaction and suggesting that the former kind of fraud is grounds for injunctive relief); Note, Letters of Credit: Injunction As A Remedy For Fraud In U.C.C. Section 5-114, 63 Minn. L. Rev. 487, 502 (1979) (contending that restricting the fraud inquiry to the credit transaction renders the words "fraud in the transaction" "nugatory"); Note, Letters of Credit: A Question of Honor, 16 N.Y.U. J. Int'l L. & Pol. 799 (1984) (arguing that, even though it renders the language of § 5-114(2) redundant, the better policy is to enjoin payment only if there is fraud in the credit transaction). Significantly, there was criticism of an early draft of the fraud rule, but that

There is nothing, furthermore, in the report of the Code's editorial board to support the position that the fraud provision contemplates fraud in the underlying transaction. In fact, the explanation of the change supports a contrary reading. In its 1956 Recommendations, the Code's editorial board explained only that subsection (2) of section 5-114 "clarifies by cross-reference the intent of old section 5-111(1) and (2)."[32] The cross references are the references to Articles 7 and 8. It is fair to infer, then, that the board considered the old subsections' reference to "forgery or fraud in a required document" to be a reference to the warranties in Articles 7 and 8. Those sections (7-507 and 8-306) related and still relate to fraud and forgery in documents of title and securities, and do not cover the host of other documents (e.g., invoices, packing lists, certificates) that also arise in the credit transaction—hence, in the board's view, the need for additional language. The additional language was introduced to make it clear that fraud in relation to papers other than documents of title or securities and fraud in obtaining documents could give the issuer grounds to dishonor.

In brief, the language of section 5-114(2) and the drafting history of the provision provide no support for those who want to extend the fraud inquiry to the underlying transaction. Those who argue for the fraud-in-the-underlying-transaction defense make two erroneous assumptions: (1) that the only way to give meaning to the "fraud in the transaction" language of section 5-114(2) is to extend it to the underlying transaction, and (2) that the language was a response to Professor Schlesinger's criticism. In addition, those advocates ignore the fact that the rule for which they argue opens the credit to an attack that virtually destroys it.

Documents Tying the Transactions Together

Frequently, courts will find in the credit transaction itself a handy excuse for plunging into the underlying transaction. If, for example, the credit refers to the underlying contract or if the documents

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criticism did not mention the fact that the early draft did not address fraud in the underlying transaction. See U.C.C. (1952 Official Text) (Supp. No. 1), reprinted in 17 E. Kelly, Uniform Commercial Code Drafts 473 (1984). The earliest published draft of the Code included a defense against payment when the beneficiary's performance in the underlying transaction created "such a non-conformity of goods as amounts to a material failure of consideration." U.C.C. IV, 1, § 22 (Tent. Draft No. 1, 1947), reprinted in 3 E. Kelly, supra, at 250. It is clear from the comments to that early tentative draft that the drafters were concerned that the issuer not have to pay the beneficiary when the goods were so defective that the bank's security was imperiled. Id. at 269-70.

[32] 1956 Recommendations, supra note 27, at 181.

refer to it, these courts promote underlying-transaction fraud to credit-transaction fraud. In one such case, the credit called for the beneficiary's draft accompanied by a copy of any instrument "causing th[e] credit . . . to be called upon."[33] The beneficiary concluded that the promissory note which the credit secured was such an instrument and presented it to the issuer along with the draft. The account party sought to enjoin payment of the credit on the grounds that if there was fraud in connection with the execution of the note, there would be fraud in the credit transaction.[34]

In many standby transactions, the credit will call for the beneficiary's certificate reciting that the account party is in default on the underlying contract or has failed to pay invoices that are due. In these cases it is easy to make the argument that fraud in the underlying transaction becomes fraud in the credit transaction. If the beneficiary defrauded the account party in the underlying transaction, arguably, the account party is not "in default," or the invoices are not "due." Under that reasoning the court will have to investigate the underlying transaction in many standby cases, since such certificates are common.

It is crucial to begin the analysis of this tying problem by understanding that any rule that permits investigation into underlying contract fraud virtually destroys the unique nature of the credit by hobbling its litigation-risk and forum-shifting functions and thereby reducing the standby to a performance bond.

Several courts have confronted the problem by saying that any reference in the credit to the underlying transaction is surplusage unless it imposes some conditions on the beneficiary.[35] That rule takes

33 O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 229, 250 S.E.2d 587, 599 (1978).

34 Id. In NMC Enter. v. CBS, 14 U.C.C. Rep. Serv. (Callaghan) 1427 (N.Y. Sup. Ct. 1974), the account party buyer caused a credit to issue in favor of a seller who allegedly used fraudulent misrepresentations to induce the buyer to enter into the underlying sales contract. The credit called for the beneficiary's certificate that payment was due under the sales contract. The court held that if the beneficiary was guilty of fraud in the underlying transaction, the payment was not due, and the certificate was false. Id. at 1430; cf. Wyle v. Bank Melli, 577 F. Supp. 1148, 1163 (N.D. Cal. 1983) (looking to underlying transaction to determine truthfulness of beneficiary's certificate); Mitsui Mfrs. Bank v. Texas Commerce Bank, 159 Cal. App. 3d 1051, 1055, 206 Cal. Rptr. 218, 220 (1984) (same). But cf. Chiat/Day Inc. v. Kalimian, 105 A.D.2d 94, 97-98, 483 N.Y.S.2d 235, 237-38 (1984) (refusing to resolve a lease dispute in order to determine whether the landlord's certification of default was false).

35 E.g., Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank, 571 F.2d 871, 874 (5th Cir. 1978); Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077, 1082 (6th Cir. 1977); Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 115 (Tex. 1978); cf. International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits, art. 3 (ICC Pub. No. 400) (1983) (providing that credit issuers shall not be concerned with underlying contracts "even if any reference whatsoever to such contract(s) is included in the credit").

care of some references in the credit but does not deal with references in the documents the beneficiary presents to the issuer. A few courts have attempted to minimize the damage to a standby credit from such certificates by imposing a heavy burden on the party claiming fraud. Thus, when the account party asserts that the beneficiary's certificate that it paid on the guaranty is fraudulent, these courts refuse to engage in a full trial on the merits of the underlying dispute, but inquire only whether the beneficiary "acts without any shred of honest belief in his rights."[36] That rule is easier to state than it is to apply and, despite protestations to the contrary, even those courts engage in protracted litigation that largely destroys the risk-shifting functions of the standby.

A better rule would fashion distinctions based on the nature of the fraud claim. If the alleged fraud or falsity in the document relates to a fact that can be ascertained without resolving underlying contract disputes, courts are well advised to consider the account party's claim. Thus, for example, if the account party alleges that the signature on a certificate is forged or that the date on an insurance document is altered, the court can probably entertain the claim without harsh effects on the standby. If the claim of fraud, however, relates to the truthfulness of an assertion that, for example, sums are due, or if the account party wants time to assemble its evidence or to engage in discovery, the court should pretermit the inquiry and leave the account party where its bargain leaves it.[37] Courts cannot grant equitable relief after lengthy litigation without seriously hampering the credit.

The Certificate's Role

The suggestion that courts should refuse to investigate complicated factual issues would require courts in most cases to deny an

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[36] Ellinger, supra note 15, at 262. Cf. Intraworld Indus. v. Girard Trust Bank, 461 Pa. 343, 359-61, 336 A.2d 316, 324-26 (1975) (defining a high threshold for the beneficiary's injunction); Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 995-96 (N.D. Ga. 1973) (same).

[37] In practice, the court nearly always grants the account party *ex parte* relief in the form of a temporary restraining order. The suit may be won or lost at the hearing a few days later on the preliminary injunction request. If the court grants that injunction, pending discovery, further hearings, briefs, and arguments, the beneficiary has lost much of his bargain. He does not receive prompt payment and must litigate without funds, often in an inconvienient forum. Issuers prefer being enjoined from paying rather than exercising the prerogative implicit in § 5-114(2)(b) of dishonoring if there is fraud. They fear damage to their reputations and are reluctant to engage in dispute resolution. Most cases, therefore, begin with the account party's request for equitable relief. In the rare case the issuer dishonors and the beneficiary must sue for damages. See, e.g., Bank of Newport v. First Nat'l Bank & Trust Co., 687 F.2d 1257 (8th Cir. 1982).

injunction against payment when the account party's claim of fraud relates to a certificate such as those that customarily arise in standby cases. When the bank that issued the guaranty letter in the defense contract illustration certifies that it properly paid on the guaranty letter, or when the lending bank in the limited partnership illustration certifies that the investors' promissory notes are due, or when, in another typical standby case, a seller certifies that invoices are unpaid and due, courts should deny equitable relief and leave the account party to its suit against the beneficiary after payment.

That denial of equitable relief does not render the certificate nugatory, for if the certificate is incorrect, the account party may maintain an action against the beneficiary either in fraud or for breach of an Article 5 warranty.[38] The certificate remains a significant feature of the standby transaction, but courts should not use it to upset the unique functions of the standby and to reallocate the litigation and forum costs in a manner different from that of the standby bargain.

Unfair Surprise

Although courts and commentators who reject the thesis advanced in this Article do not say so explicitly, there can be little doubt that it strikes some of them as unfair or unconscionable to tell the account party that it must let the transaction proceed even though its claim of fraud is valid.

There are two considerations at work here. First, it often appears that the account party who charges fraud has no adequate remedy if it loses in its efforts to stop payment.[39] In the defense contractor illustration the seller, a United States company, will have to pursue its claim in, say, Iran[40] or India,[41] and may have to do so at

38 See U.C.C. § 5-111(1), -114 comment 2, para. 2, (3d & 4th sentences). Breach of warranty, of course, is far easier to prove than common law fraud. The latter requires a showing of scienter; the former does not. To some extent litigants seem to ignore the warranty section. See, e.g., Sherkate Sahami Khass Rapol v. Henry R. Jahn & Son, 701 F.2d 1049 (2d Cir. 1983); Fertico Belgium, S.A. v. Phosphate Chems. Export Ass'n, 100 A.D.2d 165, 473 N.Y.S.2d 403, appeal dismissed, 62 N.Y.2d 802 (1984). For a general discussion of the article 5 warranty, see Dolan, Letters of Credit, Article 5 Warranties, Fraud, and the Beneficiary's Certificate, 41 Bus. Law. (forthcoming 1986).

39 In fact, if he does have an adequate remedy at law against the beneficiary under § 5-111(1) for common law fraud or for breach of the underlying agreement, the court should not issue the injunction. In order to obtain such equitable relief, the account party usually must show the absence of such a remedy. See, e.g., Rockwell Int'l Sys. v. Citibank, 719 F.2d 583 (2d Cir. 1983); Warner v. Central Trust Co., 715 F.2d 1121 (6th Cir. 1983); Harris Corp. v. National Iranian Radio & Television, 691 F.2d 1344 (11th Cir. 1982); see also supra note 29 (discussion of adequate remedy at law prerequisite for injunction).

40 There was a host of cases that arose out of the Iranian revolution, and they prompted a flurry of activity in legal journals. Most of the articles argued in favor of protecting the con-

a time when the climate between the government of the distant forum and that of the United States is unfriendly. Second, if the claim of fraud is true, some might be concerned that the seller is unfairly surprised by the turn of events and that it would never have agreed to see the downpayment or progress payments sent off to Tehran when the guaranty bank and the government buyer are practicing fraud. The unfairness appears all the more egregious when one considers that the rule advocated here leaves the defense contractor with only one resort: to litigate a claim against a fraudulent, foreign-government buyer in that same government's courts. Thus, it appears that the narrow fraud rule may deprive the account party of its remedy and that it does so without its ever agreeing or understanding that the standby credit would operate in such a fashion.

These concerns do not justify wrecking the credit. If all of these facts are true (i.e., the beneficiary is practicing fraud, the courts of the foreign jurisdiction will not dispense justice, the defense contractor is surprised to learn that the credit will be paid even when there may be fraud in the call or on payment by the guaranty issuer, and the defense contractor would not have agreed to have the payments returned to the buyer promptly and without litigation), the court should still deny the injunction and let the credit proceed.

In many cases, perhaps in most, there is no way that the court will know *ab initio* whether these facts are true. It will only know that the defense contractor claims that they are true, and it will only

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tractor at the expense of the Iranian beneficiary. See, e.g., Gable, Standby Letters of Credit: Nomenclature Has Confounded Analysis, 12 Law & Pol'y Int'l Bus. 903 (1980); Kimball & Sanders, supra note 31; Weisz & Blackman, Standby Letters of Credit After Iran: Remedies of the Account Party, 1982 U. Ill. L. Rev. 355; Note, supra note 30; Comment, supra note 30. Contra Note, A Reconsideration of *American Bell International, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979), 19 Colum. J. Transnat'l L. 301 (1981); Note, The Role of Standby Letters of Credit in International Commerce: Reflections after Iran, 20 Va. J. Int'l L. 459 (1980). The early Iranian cases tended to favor the beneficiary, but the later opinions tend to react to the lingering problem and rule against the beneficiary. See, e.g., Rockwell Int'l Sys. v. Citibank, 719 F.2d 583 (2d Cir. 1983); KMW Int'l v. Chase Manhattan Bank, 606 F.2d 10 (2d Cir. 1979).

[41] In Dynamics Corp. of Am. v. Citizens & S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973), the account party was selling communications equipment to the government of India for military uses. With the outbreak of war between India and Pakistan in 1971, the United States government embargoed certain shipments to India, including those subject to the sales agreement in question. The Indian government then drew on the standby letter of credit. The underlying contract, moreover, contained an arbitration clause requiring arbitration in New Delhi. Thus, the terms of the transaction (the standby and the arbitration clause) suggest that the buyer (India) had exercised considerable bargaining strength. For an argument that these cases are the rule rather than the exception in letter of credit litigation, see Zimmett, Standby Letters of Credit in the Iran Litigation: Two Hundred Problems in Search of A Solution, 16 Law & Pol'y Int'l Bus. 927 (1984).

decide after hearing and arguments by counsel that the evidence indicates that they are more probably true than not. The rule that permits the courts to engage in wide-ranging fraud inquiry invites account parties to allege these facts. Courts should reject wide-ranging inquiry because the very presence of a rule permitting it could ruin the standby.

The unique features of the credit (prompt payment that shifts litigation and forum costs) that distinguish it from the performance bond and the escrow arrangement do not survive in the presence of such a rule. The credit is an efficient commercial invention, and the rule permitting wide-ranging fraud inquiry destroys it.

Even if all of the fraud and unconscionability facts are true, courts generally should deny equitable relief. If the facts are true, the case is hard; but law responding to these facts would be bad. Only if the facts are beyond dispute should the court weaken the credit to protect the account party. Courts are not dealing with consumers. They are dealing with defense contractors, investors seeking tax shelters, and other business people. The need for the law to protect unwitting consumers may justify relatively high transaction costs in retail sales. The need for the law to protect the unwitting businessman, however, does not justify relatively high transaction costs in nonconsumer transactions. If persons engaged in business activity do not learn about commercial specialties or do not engage a lawyer who does, let them pay the costs of their ignorance. To protect them by destroying the credit is to tax the rest of us with higher costs.

V. THE UNSTATED PREMISE

It may be that the treatment of standby credits by courts and the view of them held by many commentators spring from the fact that they do not understand the credit invention and do not appreciate the significance of the arguments they make. The history of merchant devices and their difficulties in finding acceptance in common law courts provide strong evidence that there may be an antimerchant dynamic at work. Courts and commentators find justification for their antimerchant position in one or both of two views: (1) that merchant inventions are attempts by merchants to take advantage of somebody; or (2) that courts, not merchants, should make legal rules. These views rest perhaps on a further prejudice that merchants are not so concerned with the common good as others are, or at least as lawyers and judges are. These are serious accusations, tentatively made, because they are impossible to prove. There is a history, however, of court treatment of merchant inventions that supports them.[42]

The balance of this Article considers a number of incidents strikingly similar to present judicial treatment of standby credits. In each case, courts resisted efficient merchant inventions. The opinions suggest that the courts either did not understand the innovation or did not care to understand, so satisfied were they in advance that the merchant idea was no good.

The Promissory Note

No event in the common law's history illustrates these premises better than Lord Holt's campaign against the promissory note. In a series of sharp and sometimes intemperate opinions, Holt castigated merchants for persisting in their attempt to use the note as a negotiable instrument.[43] He considered that activity to be an attempt by merchants to dictate the law. Ultimately, in the Statute of Anne,[44] Parliament overturned Holt's decisions. But there is evidence that Holt played a supportive role in the adoption of that legislation. It may be fair to conclude that Holt did not oppose promissory notes: he recognized their commercial merit, but he could not abide the fact

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42 There is no suggestion here that all courts and lawyers are disposed to reject merchant inventions. To the contrary, there is abundant evidence that many judges are receptive to merchant innovation. See the discussion of Lord Mansfield's treatment of extrinsic acceptances at notes 62-85 and accompanying text. Professor Horwitz has established conclusively that many antebellum judges were bent on fashioning law that would enhance the cause of a commercial republic. See M. Horwitz, The Transformation of American Law 1780-1860 (1977). This Article suggests only that some courts have been inhospitable toward merchant innovations, perhaps to an unreasonable degree.

43 There are three characteristics of negotiability:

> (i) Negotiable instruments are transferable by delivery if made payable to bearer, or by indorsement and delivery if made payable to order; and the transferee to whom they have been thus delivered can sue upon them in his own name. (ii) Consideration is presumed. (iii) A transferee, who takes one of these instruments in good faith and for value, acquires a good title, even though his transferor had a defective title, or no title at all.

Holdsworth, The Origins and Early History of Negotiable Instruments (pt. 1), 31 L.Q. Rev. 12, 12 (1915). The promissory note controversy generally concerned the first two features. The bill-of-lading controversy, discussed infra at notes 92-106 and accompanying text, concerned the third. For a general discussion of the "old" instruments, see Baker, The Law Merchant and the Common Law Before 1700, 38 Cambridge L.J. 295 (1979); Beutel, The Development of Negotiable Instruments in Early English Law, 51 Harv. L. Rev. 813 (1938); Holdsworth, The Origins and Early History of Negotiable Instruments (pts. 1-4), 31 L.Q. Rev. 12, 173, 376 (1915), 32 L.Q. Rev. 20 (1916), reprinted in 8 W. Holdsworth, A History of English Law 113 (2d. ed. 1937); Jenks, The Early History of Negotiable Instruments, in 3 Select Essays in Anglo-American Legal History 51 (1909); see also, 2 Bracton, On the Laws and Customs of England 285, 287 (S. Thorne trans. 1968) (describing such instruments).

44 For discussion of the statute and Lord Holt's role in connection with it, see infra text accompanying notes 66 and 67.

that their introduction into the common law scheme of things was the work of goldsmiths, private citizens.

The story begins with the bill of exchange. While merchants had used instruments with some primitive features of negotiability[45] before the bill,[46] those instruments apparently did not survive the transfer of jurisdiction over merchant matters from the merchant and admiralty courts to the common law courts in the sixteenth and seventeenth centuries. Merchants, however, managed to save the bill, which because of its role in international trade survived the hostility of common law judges.[47] Gradually, the merchants adapted it to purely domestic trade and thereby used it as a substitute for the "currency" function of the old instruments.

It is important to understand that paper currency was absolutely indispensable to any kind of trade beyond the barter point.[48] Negotiable paper served that currency function until the advent of bank credit—a phenomenon of the last 150 years. Today, we conduct trade by transferring credits in deposit accounts (by check or wire transfer) or under lines of credit (by credit card and the like); we use paper currency as petty cash. In prior centuries, the banking system could not play the role it plays today. When a merchant in seventeenth century Bristol wanted to transfer £100 to a London merchant he faced a serious dilemma. First, though his personal wealth (accounts and inventory) might exceed that sum, he probably did not have enough coin to transfer. Second, even if he had silver or gold, he did not dare send his servant to London with it for the same reason we do not send large sums on highways or city streets today—he feared thieves and accidents. If he could not resolve the dilemma, he could

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45 Beutel argues that the negotiability concept in the first sense described by Holdsworth, (pt. 1), supra note 43, at 12, had matured in the merchant courts long before common law courts accepted it. See Beutel, supra note 43, at 832, 839; accord Brodhurst, The Merchants of the Staple, 17 L.Q. Rev. 56, 58 (1901).

46 In the classic bill of exchange transaction, there were four parties: *A*, who wanted to convey money to *D*; *B*, who was an "exchanger"; *C*, who was *B*'s correspondent in *D*'s city; and *D*, the party whom *A* wanted to pay. *A* would then deliver the money to *B*. *B* would draw a bill on *C* ordering *C* to pay *D*. *B* would give the bill to *A* who would send it to *D*. *D* would then present it to *C* for payment. For an early modified version of this transaction, see Martin v. Boure, 79 Eng. Rep. 6 (Ex. 1602); see also Holdsworth, (pt. 4), supra note 43, at 21.

47 Alcaster claims that one reason for the success of the bill was that it permitted merchants to avoid violating the usury laws. Although merchants could not charge interest for money loaned they could "exchange" one currency for another at premiums that served the same function as interest. Alcaster, Banking in London: The Beginning, 146 Three Banks Rev. 43, 44 (1985).

48 2 F. Braudel, The Wheels of Commerce 112-13 (S. Reynolds trans. 1982). Paper currency achieved such importance and widespread use in the 18th century that by one estimate it out-valued "hard" currency by a ratio of 15:1. Id.

not trade. He did resolve it with the inland bill. When a Bristol trader wanted to pay a London merchant for wool that was on the docks at Bristol, the trader could give value to *B* and direct *B*, a Bristol exchanger, to order *C*, his London correspondent, to pay the London merchant. That order was the bill of exchange.

These bills apparently became common during the first half of the seventeenth century and eventually, by means of indorsement, merchants transferred them from hand to hand several times before they were retired by payment. The indorsement played a key role in the popularity of the bill because it gave value to it. A trader selling goods at Exeter, for example, might not know the Bristol exchanger who drew the bill. If, however, he knew the London merchant who held the bill and valued the merchant's credit, the Exeter trader would sell goods against the merchant's indorsement and delivery knowing that he could recover from the merchant indorser if the London house defaulted.[49]

It is impossible to know when or why the promissory note first appeared on the English commercial scene. The note had its antecedents in the merchant courts,[50] but the early common law decisions confuse the note with the bill.[51] By 1702, however, it was clear that Holt understood the difference and was not about to let the note insinuate itself into the common law.[52]

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49 The example in the text illustrates the crucial role negotiability plays in the transaction. If the bill were not negotiable, the Exeter trader could sue the drawer of the bill, *B*, only in the name of the original payee, *D* (the indorser), and only by the indorser's leave. Ward v. Evans, 92 Eng. Rep. 120 (K.B. 1702).

50 See Beutel, supra note 43, at 839; Holdsworth, (pt. 3), supra note 43, at 380-81.

51 Ward v. Evans, a case decided at the height of the promissory note controversy, exemplifies the confusion. Holt's campaign against the note rested on the fact that notes were different from bills, yet three of the four reports of the *Ward* case hopelessly confuse the two. See Ward v. Evans, 87 Eng. Rep. 799, 90 Eng. Rep. 965, 91 Eng. Rep. 383 (K.B. 1702). Only Lord Raymond, whom Campbell calls Holt's "pupil" and who later was himself Chief Justice, avoided the confusion, though he slipped once. See Ward v. Evans, 92 Eng. Rep. 120, 120 (K.B. 1702); 3 J. Campbell, The Lives of the Chief Justices of England 20 (1878). Mansfield complained that in the early cases, without searching the record, one cannot tell whether they arose upon promissory notes or inland bills of exchange and that "the reporters . . . use[d] the words 'note' and 'bill' promiscuously." Grant v. Vaughan, 97 Eng. Rep. 957, 961 (K.B. 1764).

52 Cranch argues, moreover, that Holt changed the law in the promissory note cases, that is, promissory notes were negotiable at common law before *Clerke v. Martin*. See Note A to Mandeville v. Riddle, 5 U.S. (1 Cranch) 290, 367, 2 L. Ed. 112, 139 (1803). Cranch's thesis is particularly significant. He went to great lengths in his "Note" to the *Mandeville* case to establish his point because many American jurisdictions had not adopted the Statute of Anne. If the statute changed the law, promissory notes in those American jurisdictions would not have been negotiable. Clearly, Cranch wanted to guard against that possibility. Currency was scarce after the American Revolution, and by 1803 promissory notes were being used extensively in American commerce and had surpassed bills of exchange in commercial importance. See M. Horwitz, supra note 42, at 212-26; W. Nelson, Americanization of the Common Law

In a series of decisions, Holt attacked the note and effectively hampered its usefulness even though he had recognized the bill as a negotiable instrument.[53] In the late seventeenth century, common law courts would hear an action on the case upon bills of exchange "according to the usage of merchants."[54] By casting his claim in terms of merchant usage, the holder of the bill realized the advantages of being able to sue in his own name, even if he was an indorsee, and of not needing the leave of the payee to sue in the payee's name. He also enjoyed good title and a presumption of consideration.

Holt objected when merchants attempted to assert the same privileges for promissory notes.[55] He saw that attempt as one to introduce a new commercial specialty into the common law and, jealous of Guildhall's prerogatives, went to some lengths, with an occasional display of temper,[56] to oppose it.

81-82 (1975). In *Mandeville*, the court initially held that the holder could not sue a remote indorser at law but later found cause to permit the suit in equity. Mandeville v. Riddle, 5 U.S. (1 Cranch) 290 (1803); Riddle v. Mandeville, 9 U.S. (5 Cranch) 322 (1809). Horwitz finds this shift from no cause of action at law in the first *Mandeville* case to a good cause in equity in the second as the worst sort of instrumental fashioning "out of the blue." M. Horwitz, supra note 42, at 223. The idea that equity would recognize such an action, however, was apparently current in the United States (or at least in Vermont) as early as 1793. See Chipman, A Dissertation on the Negotiability of Notes, 1 Vt. (1 N. Chip.) 89, 94-95 (1879). In a recent article, Fletcher contends that this unsettled state of American negotiable instruments law prompted the articulation in Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842), of the rule that federal or general common law governed commercial matters. Fletcher, The General Common Law and Section 34 of the Judiciary Act of 1789: The Example of Marine Insurance, 97 Harv. L. Rev. 1513, 1516 (1984); accord Dickinson, The Law of Nations as Part of the National Law of the United States (pt. 2), 101 U. Pa. L. Rev. 792, 795-803 (1953).

53 See Buller v. Crips, 87 Eng. Rep. 793 (K.B. 1703); Clerke v. Martin, 92 Eng. Rep. 6 (K.B. 1702); Potter v. Pearson, 92 Eng. Rep. 7 (K.B. 1702); Cutting v. Williams, 87 Eng. Rep. 1160 (K.B. 1702).

54 See Williams v. Williams, 90 Eng. Rep. 759 (K.B. 1693).

55 In Potter v. Pearson, 92 Eng. Rep. 7 (K.B. 1702), Holt complained that the alleged custom of merchants with respect to notes was void, "since it binds a man to pay money without any consideration." Id. at 7. In Buller v. Crips, 87 Eng. Rep. 793 (K.B. 1703), he complained that the indorsee may sue the maker of a note but only in the name of the payee. Holt agreed that bills were specialties, and he saw an action by a merchant to declare on a note according to the custom of merchants as amounting "to the setting up a new sort of speciality, unknown to the common law." Clerke v. Martin, 92 Eng. Rep. 6, 6 (K.B. 1702). Holdsworth denied that bills were specialties. See Holdsworth, (pt. 4), supra note 43, at 29. Cranch was in accord. See Cranch, supra note 52, at 412-13, 2 L. Ed. at 157. Hershey argued that bills, notes, and checks were "recognized instruments of the law merchant." Hershey, Letters of Credit, 32 Harv. L. Rev. 1, 10 (1918). Thayer used the term "mercantile speciality." Thayer, Irrevocable Credits in International Commerce: Their Legal Nature, 36 Colum. L. Rev. 1031, 1059 (1936).

56 Story characterized Holt's campaign against the note as proceeding "with a pride of opinion not altogether reconcilable with his sound sense, and generally comprehensive views." J. Story, Commentaries on the Law of Promissory Notes 8 (2d ed. Boston 1847). Cranch said that Holt's opinion in the *Clerke* case shows that "from some cause or other, he was extremely irritated with the goldsmiths." Cranch, supra note 52, at 416, 2 L. Ed. at 159. In Grant v.

Holt's reaction appears to stem from what he considered to be the recalcitrance of the goldsmiths.[57] In this view, the bill satisfied the merchants' need for currency. The key to the controversy might well lie in Holt's emphasis that it was goldsmiths, not merchants and trad-

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Vaughan, 97 Eng. Rep. 957 (K.B. 1764), one of the plaintiff's attorneys in oral argument characterized Holt's conduct in the *Clerke* case as "peevish," id. at 959. Mansfield, in another report of the same case, acknowledged that merchant efforts to make inland bills into specialties "made Holt so angry." Grant v. Vaughan, 96 Eng. Rep. 281, 282 (K.B. 1764). For some of the language evidencing that irritation, see infra note 57. The goldsmith had benefitted indirectly from Charles I's misconduct. The well-to-do of 17th-century England stored their wealth in the Tower of London for lack of a better place. Shortly before the civil war broke out in 1638, Charles forcibly borrowed £200,000 from the Tower. Although he did pay off this loan within a few months, confidence in the Tower as a repository of funds was never fully restored. J. Holden, The History of Negotiable Instruments in English Law 71 & n.1, 72 (1955). Thus, by seizing the landowners' and the merchants' money from the Tower, Charles prompted them to look elsewhere for storage. They turned to the goldsmith. He would issue receipts evidencing the precious bailments and his status changed from that of smith to that of custodian. Further enhancing his position as *de jure* banker, the goldsmith began paying interest on funds left with him, possibly even before the civil war ended. J.W. Gilbart, History and Principles of Banking 19 (1866).

Later, the receipt gained a degree of currency and became the goldsmith's note. Apparently some of the goldsmiths became rich: the King had to borrow from them, and they charged high rates. By 1676 resentment against them had advanced sufficiently to prompt the publication of a pamphlet asserting that "The King and Kingdom Became Slaves to these Bankers." The Mystery of the New Fashioned Goldsmiths (1676), reprinted in J. Martin, The Grasshopper in Lombard Street 287 (reprint 1892). See generally A. Andreades, History of the Bank of England 23-25 (1909) (explaining the way goldsmiths became bankers and the hostility to that metamorphosis). Thus, Holt's animus against the goldsmith may not have been unusual. Even though Holt recognized in Buller v. Crips, 87 Eng. Rep. 793 (K.B. 1703), that a bill of exchange could be a two-party instrument, he would not treat the note as a bill. He could have done so without a great deal of violence to reality, by treating the making of a note as an acceptance of a bill—a fiction only one-half step from his treatment in *Buller* of the payee's indorsement of the note as a new bill. Justice Buller claims that the goldsmiths were campaigning to make their note negotiable. They were not satisfied to recover on a given note but evidently instructed their lawyers to sue on the custom of merchants in order to force the issue that notes would be universally considered on the same footing as bills. See Brown v. Harraden, 100 Eng. Rep. 943, 946-47 (K.B. 1791).

[57] But Holt Chief Justice was totis viribus against the action; and said, that this note could not be a bill of exchange. That the maintaining of these actions upon such notes, were innovations upon the rules of the common law; and that it amounted to the setting up a new sort of specialty, unknown to the common law, and invented in Lombard-Street, which attempted in these matters of bills of exchange to give laws to Westminster-Hall. That the continuing to declare upon these notes upon the custom of merchants proceeded from obstinacy and opinionativeness, since . . . there was so easy a method, as to declare upon a general indebitatus assumpsit for money lent, &c.

Clerke v. Martin, 92 Eng. Rep. 6, 6 (K.B. 1702). In another report he stated: "[A]nd the notes in question are only an invention of the goldsmiths in Lombard-Street, who had a mind to make a law to bind all those that did deal with them . . . ." Buller v. Crips, 87 Eng. Rep. 793, 793 (K.B. 1703). And in yet another case: "But then I am of opinion, and always was (notwithstanding the noise and cry, that it is the use of Lombard-Street, as if the contrary opinion would blow up Lombard-Street) that the acceptance of such a note is not actual payment." Ward v. Evans, 92 Eng. Rep. 120, 121 (K.B. 1702).

ers, who insisted on the note. It was not from Bristol or Portsmouth that the declarations came, but from Lombard Street where the bankers maintained their houses.

Holt argued that merchants could easily fashion the bill, normally a three-party instrument, into a note, a two-party instrument. Thus, if as Story later claimed,[58] the Bristol buyer was a small trader and could not draw on a third party (not having credit enough to do so), Holt would have him accept a bill drawn on himself by the seller.[59]

Holt's suggestion may well have satisfied the merchants and traders, but it did not satisfy the goldsmiths. Holt was cutting them out of the transaction. For the payee, furthermore, the acceptance of a small trader only carried the engagement of the acceptor. The payee would much prefer to have the small trader indorse a note made by a goldsmith of good credit repute. The payee of such a note could look to the small trader, who was an indorser and, more importantly, to the goldsmith as maker. The note, then, had advantages over the bill. It gave more credit to the small trader who held a goldsmith's note,[60] and it enhanced the commercial role of goldsmiths and facilitated the process of intermediation that they were beginning to assume.[61]

Holt surely understood the different functions of the two merchant devices, but he would respond that it was just as easy for a goldsmith to accept a bill for £15 after the depositor drew the bill as it was for the goldsmith to draw a promissory note for £15 payable to the depositor. Indeed, he made that response in *Buller v. Crips*. That Holt's response was insufficient is obscure. If the issue was one of form, it is hard to believe that the goldsmiths would not have capitulated; but they did not. They took the controversy to Parliament. It may be that the goldsmith's notes had, by the beginning of the eighteenth century, achieved a measure of attraction that the goldsmiths were reluctant to forfeit. Perhaps it was a marketing consideration. Whatever the reason, the goldsmiths and their political allies were sufficiently agitated by the prospect of losing the note that they brought political pressure to bear and saved it. Although there are suggestions that notes were at that time a recent invention,[62] they

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[58] See J. Story, supra note 56, at 7.

[59] See Buller v. Crips, 87 Eng. Rep. 793 (K.B. 1703).

[60] The trader may have been a depositor or borrower who took the goldsmith's note as payee, but the trader may also have been one who took the note from another. The note served as currency, passing from seller to seller. 8 W. Holdsworth, supra note 43, at 172, 188-92.

[61] See A. Andreades, supra note 56, at 23; J. Martin, supra note 56, at 129.

[62] In Ward v. Evans, 87 Eng. Rep. 799 (K.B. 1702), one of the attorneys, undoubtedly aware of Holt's predisposition, referred to the goldsmiths's note as "a very new invention,

eventually overtook the bill, assuming a more important role in the domestic credit economy than that of the bill. Bills remained the more esoteric device of the international trader.[63]

When in 1704 the Statute of Anne overturned the effect of Holt's cases by rendering promissory notes negotiable in the same manner as bills, it accepted the goldsmiths' argument that notes would advance trade and commerce[64] but did not necessarily reject Holt's argument. Holt was not objecting to notes, but to the fact that goldsmiths were fashioning legal rules.[65] In fact, Campbell claims that Holt "suggested" the statute to Parliament,[66] though Holdsworth assigns him a more modest role.[67] Holt may well have supported the legislation, which facilitated the note without the anomaly of Lombard Street's dictating the law to Guildhall.

Extrinsic Acceptances

The hostility with which the promissory note was confronted at the end of the seventeenth century is similar to that with which the letter of credit and the virtual acceptance were confronted at the beginning of the nineteenth.

There is evidence that as early as the seventeenth century[68] merchants involved in trade with England used bills of exchange denominated in pounds sterling both as currency and as a means of granting credit. Much of international trade from the seventeenth to

already obnoxious to such practices as deserve no encouragement." Id. at 800. In fact, the note was not so recent. It was only the distinction between notes and bills that was recent. See supra note 51.

63 Story claimed that by the beginning of the 18th century the note was far more prominent in England than the bill. See J. Story, supra note 56, at viii. According to Friedman, the career of the note in 18th-century American commerce was widespread in domestic sales transactions. See L. Friedman, A History of American Law 236 (1973); see also M. Horwitz, supra note 42, at 215 (same); W. Nelson, supra note 52, at 43, 81-82 (same). Today, the promissory note has lost virtually all of its character as currency. For accounts of the uses of bills in international trade, see generally S. Bruchey, Robert Oliver, Merchant of Baltimore 1783-1819 (1956); E. Perkins, Financing Anglo-American Trade, The House of Brown, 1800-1880 (1975).

64 1704, 3&4 Anne, ch. 8.

65 Baker, defending Holt, points out that the common law was immutable. The law merchant, on the other hand, was in a constant process of revision, the advent of the promissory note being but one instance of that process. The problem, then, was two-fold: "Shifting usages can hardly be treated as common law;" and "it is not competent to private subjects thus to dictate changes in law to the courts." Baker, supra note 43 at 298, 299.

66 3 J. Campbell, supra note 51, at 21.

67 Holdsworth, (pt. 4), supra note 43, at 35 & n.1.

68 See B. Bailyn, The New England Merchants in the Seventeenth Century 34-35, 98 (1955). There is also evidence that credit in international sales was common long before the 17th century. See Postan, Credit in Medieval Trade, 1 Econ. Hist. Rev. 234 (1927); Usher, The Origin of the Bill of Exchange, 22 J. Pol. Econ. 566, 569 (1914).

the nineteenth centuries was conducted by barter with specie or sterling bills providing the "change."[69] Eventually, however, the bill achieved a dominant role.

First, as an instrument of credit, the bill facilitated an exporter's ability to use his inventory as security for advances. Thus, when Scroder, an Irish corn merchant, consigned his grain to a Liverpool merchant, he would draw a bill on the Liverpool house for a percentage of his corn's value and discount the bill locally. The bill would be a time bill payable, say, sixty days after sight. The holder of the bill, who might be Scroder's indorsee or a subsequent indorsee, would present the bill to the Liverpool house which would accept it, pay it when it matured, and later sell the corn and use the proceeds to reimburse itself. This use of the bill facilitated the importation of goods into England.[70]

In the second case, the bill facilitated English exports in much the same way the modern draft, drawn under a commercial letter of credit, does today. The English house would issue a credit in favor of a seller, allowing the seller to draw time bills on the issuer. The issuer would then put itself in funds when a foreign buyer paid for the seller's goods.[71] The houses that issued these credits to English exporters were usually the same houses that granted advances to foreign sellers for import. In fact, the houses, which by virtue of these functions came to be called merchant bankers, used the system of advances and credits to solicit business for their own trading activity. By the middle of the nineteenth century, London houses were financing a considerable portion of English and American international trade in this fashion.

In connection with both types of bill (that drawn by a foreign seller and that drawn by an English seller), the value of the bill often depended on the rank of the house named as the drawee and on the predictability that the house would honor.[72] The merchants (both the

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69 S. Bruchey, supra note 63, at 40; N. Buck, The Development of the Organisation of Anglo-American Trade 1800-1850, at 117-20 (1925); E. Perkins, supra note 63, at 5.

70 Such use of the bill in the case of Mr. Scroder, however, turned out to be problematic when a court ruled that the promise of the Liverpool house to accept the bill was not enforceable. See Bank of Ir. v. Archer, 152 Eng. Rep. 852 (Ex. 1843).

71 The foreign buyer might pay by a bill, drawn on the same or a different merchant banker, that he took in payment for the sale of his merchandise; or he might pay by credit for merchandise consigned to the English house that issued the credit.

72 Anyone could draw a bill, but the value of the bill (i.e., its acceptability by third parties and the measure of its discount) depended on the credit reputation of the drawee himself and the likelihood that the drawee would accept. A strong drawer would stand behind his bill, but takers would prefer a strong drawee whose honor was predictable. Collection against the drawer after the drawee's dishonor entailed delay and expense.

bankers and the traders) soon realized that they could enhance the value of a foreign seller's bill in Charleston or Waterford or elsewhere if the drawee house announced in advance that it would honor the bill on presentation.

These announcements and the credits issued on behalf of English exporters were novel adaptations of the traveler's letter of credit that had been used long before the Industrial Revolution.[73] The traveler's letter itself found use in the eighteenth and nineteenth centuries when merchants sent their agents (ship captains or supercargoes) to foreign ports. When the agents needed to pay for return cargo or port privileges, they would draw bills on the merchant. They would enhance the value of the bills by displaying the letters of credit they brought with them that were issued by the merchants who had engaged to honor the bills.

The merchants of the eighteenth and nineteenth centuries had achieved a measure of efficiency with these promises to accept bills. The promise was extrinsic to the bill, because most of the time it was made before the bill was drawn. Thus, in an important way, the promise to accept was different from the acceptance itself, which appeared on the document, usually on its face.

The extrinsic acceptance responded to felt commercial need, but the English courts were more interested in legal than commercial problems. First, some of the courts were greatly troubled by the fact that enforcement of promises to accept amounted to enforcement of an acceptance that was extrinsic to the bill. An acceptance is a negotiable instrument, and the idea that liability on a negotiable instrument can arise by a writing that is not on the instrument and that may have been made even before the instrument was drawn,[74] troubled common law judges. In addition, some courts noted that the holder of the bill was not in privity with the party that made the promise and that, frequently, there was no consideration to support the promise.

None of these objections concerned Lord Mansfield who saw the matter as one of "great consequence to trade and commerce, in every light."[75] Given that conclusion, Mansfield rode roughshod over tech-

[73] For a traveller's letter of credit issued by King John in 1202 to his agents who were travelling to Rome to purchase goods, see L. Goldschmidt, Universalgeschichte des Handelsrechts 427 (1891), quoted in Usher, supra note 68, at 569.

[74] An acceptance made after the bill was drawn but not noted on the face of the bill was an "extrinsic" acceptance. An acceptance made before the bill was drawn was a "virtual" acceptance. See generally, Finkelstein, Acceptances and Promises to Accept, 26 Colum. L. Rev. 684 (1926).

[75] Pillans v. Van Mierop, 97 Eng. Rep. 1035, 1038 (K.B. 1765).

nical complaints. In the celebrated case of *Pillans v. Van Mierop*[76] he ruled that no consideration was necessary to support the engagement and that a promise to accept amounted to an acceptance, even though made before the bill came into existence. Later, in *Pierson v. Dunlop*[77] he distinguished an acceptance (a promise communicated to the holder) from a letter of credit (a promise communicated to the drawer) and held again that the promise to the drawer should be enforced if it is given in circumstances that induce a third party to take the bill. In short, Lord Mansfield thought that the issuers of these promises meant to be bound and did so to accommodate commerce and trade. He was willing, therefore, to enforce the promises.

Unfortunately, in *Pillans* Mansfield gave vent to his own frustration with the doctrine of consideration; and his view, though at once well-grounded in history and prescience,[78] prompted strong reaction. Mansfield said in *Pillans* that the doctrine of *nudum pactum*, first of all, had no place in contracts between merchants; and second, should not apply to written promises. Justice Wilmot's comments in *Pillans* are somewhat lengthier and make the same point as to written contracts.[79]

It is conventional learning that thirteen years after *Pillans* the House of Lords overruled it in *Rann v. Hughes*.[80] Holdsworth[81] and Pollock[82] make that assertion, and others agree.[83] It is true that *Rann v. Hughes* contains language that casts doubt on the vitality of *Pillans*,

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76 97 Eng. Rep. 1035 (K.B. 1765).

77 98 Eng. Rep. 1246 (K.B. 1777); cf. Mason v. Hunt, 99 Eng. Rep. 192 (K.B. 1779) (dictum to the same effect).

78 If he misstated the rule in *Pillans*, Lord Mansfield nonetheless was correct in assuming that the efficient commercial device (the promise to accept) would be far easier to use without requiring consideration to support it. The UCC abolishes the need to show consideration. See U.C.C. § 5-105. The English courts have resorted to various fictions to find consideration, none of them satisfactory. See H. Gutteridge & M. Megrah, The Law of Bankers' Commercial Credits 24-33 (6th ed. 1979).

79 97 Eng. Rep., at 1038-41.

80 101 Eng. Rep. 1014 n.a (H.L. 1778).

81 8 W. Holdsworth, supra note 43, at 29-30.

82 F. Pollock, Principles of Contract 188-89 & 191 n.x (8th ed. 1911).

83 The authorities, however, generally see *Pillans* as a case involving the general doctrine of consideration, which *Rann* clearly reinstates as to nonmercantile settings. See G. Gilmore, The Ages of American Law 7-8 (1977); G. Gilmore, The Death of Contract 18 (1974); M. Horwitz, supra note 42, at 178; McCurdy, Commercial Letters of Credit, 35 Harv. L. Rev. 539, 565 (1922). Farnsworth says that Mansfield was attempting to revive the idea that "simple promises made in commerce should be enforced" and that *Rann* repudiated the effort. Farnsworth, The Past of Promise: An Historical Introduction to Contract, 69 Colum. L. Rev. 576, 592 & n.69 (1969). Others view *Pillans* as support for its narrower holding that a letter of credit is a speciality that imports consideration. See Cranch, supra note 52, at 445 n.1, 2 L. Ed. at 171 n.1; Trimble, The Law Merchant and the Letter of Credit, 61 Harv. L. Rev. 981, 989 (1948).

but to say that *Rann* by itself overrules *Pillans* is an exaggeration. *Rann* involved an attempt to fasten personal liability on an administratrix for an unsupported promise to pay her decedent's debt. The reporter in *Rann* recites that the Lord Chief Baron thought that in his discussion of *nudum pactum* Justice Wilmot had "contradicted himself, and was also contradicted by Vinnius in his comment on Justinian."[84] Later in the report, Lord Chief Baron Skynner mentioned *Pillans* and a second case, and the reporter observed: "[S]o far as these cases went on the doctrine of nudum pactum, he seemed to intimate that they were erroneous."[85]

While some have argued that the history of Mansfield and Wilmot in *Pillans* was better than that of the Lord Chief Baron in *Rann*,[86] the fact remains that *Rann* casts doubt on the *nudum pactum* reasoning of *Pillans*. It is not clear from *Rann*, however, that the balance of *Pillans* is suspect. The three *puisne* justices in *Pillans* found that there was consideration for a London house's promise to accept the draft of a Rotterdam house. The holding on the contested issue in *Pillans* (that a merchant promise to accept a draft is enforceable even though it is made before the draft is drawn) does not fall under the rule of *Rann* (that a nonmerchant promise to pay a debt is not enforceable if it is not supported by consideration).

Nonetheless, later English cases seized upon the *Rann* holding to render merchant promises to accept drafts unenforceable if the drafts were not in existence when the promise was made.[87] The cases appear to rest upon the justices' dissatisfaction with three features of *Pillans*. First, they regretted the fact that an acceptance could exist outside the four corners of the bill.[88] Second, they professed disdain for a rule

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[84] *Rann*, 101 Eng. Rep. 1014 n.a.

[85] Id. at 1015 n.a.

[86] It was by inquiring into the origin of the rule of law that consideration is necessary to support a simple contract that Lord Mansfield fell into error when he held, doubtless to the astonishment of the profession, in *Pillans v. Van Mierop*, that an agreement evidenced by a document under hand only, but without consideration, could be supported. As Sir William Holdsworth and Sir Frederick Pollock have shown, historically Lord Mansfield's opinion was correct, but it was too late in 1765 to question what had become a rule of law . . . .

Terrell v. Colonial Secretary, [1953] 2 All E.R. 490, 496 (Q.B.) (footnote omitted).

[87] See Bank of Ir. v. Archer, 152 Eng. Rep. 852, 854-55 (Ex. 1843); Johnson v. Collings, 102 Eng. Rep. 40 (K.B. 1800).

[88] In Johnson v. Collings, 102 Eng. Rep. 40, 42 (K.B. 1800), Lord Kenyon "lamented that any thing has been deemed to be an acceptance of a bill of exchange besides an express acceptance in writing" after the bill is drawn. And, in Clarke v. Cock, 102 Eng. Rep. 751, 757 (K.B. 1803), Judge Lawrence said: "It would have been much better doctrine if it had been originally determined that nothing else should amount to an acceptance than a written acceptance on the bill itself." The *Clarke* court enforced an *extrinsic* acceptance (i.e., an acceptance ex-

that would give rights to one indorsee of the bill and not to others.[89] And third, they saw the *Pillans* case as permitting the assignment of a chose in action—a doctrine to which they were loathe to subscribe.[90]

This dissatisfaction, especially on the last point, is a manifestation of the common law's inability to cope with the idea that an intangible obligation (a chose in action) could be transferred. To permit such transfers would, the common law judges were certain, open the obligor to a flood of fraudulent claims by the original obligee who had transferred the obligation. These claims could be brought by a subsequent transferee who had transferred it, or by a complete stranger who claimed that he was a transferee. Absent the presence of any tangible chose whose possession could serve to validate the claim of the true obligee, the courts would not abide the transfer.

The fact that those fears proved unfounded is not itself a sufficient criticism of English judicial treatment of extrinsic acceptances. The fact that the merchants needed the device and were making it work is sufficient criticism. The courts failed to give the invention its proper due; they failed to observe its success.

As a matter of commercial reality, a merchant banker would make its promise to the drawer to induce him to consign merchandise to the London house. Also, as a matter of practical necessity, a merchant giving a letter of credit to a supercargo embarking on a sea voyage with hopes of returning with foreign merchandise had to give the credit before the foreign seller's bills were drawn. Mansfield ruled, as a matter of good sense, that only takers of the bill that relied on the promise should be able to enforce it. These commercial realities and good sense did not phase the English justices, however. Without ever contradicting Mansfield's assertion that the question was one of consequence to trade and commerce, the English courts chose to serve their own legal distinctions, misread the history of *nudum pactum*, misconstrued *Rann v. Hughes,* and gave the back of their hand to the needs of trade and commerce.[91]

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trinsic to the bill but one made after the bill was drawn); the *Johnson* court refused to enforce a *virtual* acceptance.

89 Justice Parke objected that such a result "would lead to an extraordinary state of things." Bank of Ir. v. Archer, 152 Eng. Rep. 852, 854 (Ex. 1843).

90 Johnson v. Collings, 102 Eng. Rep. 40, 42 (K.B. 1800). Although Rann v. Hughes is more often cited as overruling *Pillans*, Lord Dennison dealt a second sharp blow to *Pillans* in Eastwood v. Kenyon, 113 Eng. Rep. 482 (K.B. 1840). In *Eastwood* the court rejected the *Pillans* notion that moral obligation in a general way could satisfy a want of consideration. Id. at 487 n.a. See 8 W. Holdsworth, supra note 43, at 32-42.

91 Ultimately, Parliament distinguished promises to accept from acceptances by abolishing virtual and extrinsic acceptances. See Bills of Exchange Act, 1878, 41 & 42 Vict. ch. 13, § 1; Mercantile Law Amendment Act, 1856, 19 & 20 Vict. ch. 97, § 6; Regulation of Acceptances

Bills of Lading

By the middle of the nineteenth century, internal expansion and the advent of the railroad made the inland bill of lading an important American trade device. St. Louis merchants, for example, who wanted to sell cotton in eastern markets would deliver bales to a railroad in return for a negotiable through bill[92] and would then draw a draft on the Philadelphia firm that had agreed to buy the cotton. By this time commercial banks had assumed a role in the payments system that permitted the St. Louis seller to cash out the cotton contract quickly. He would discount his draft with a local bank that would take the draft with the bill attached[93] and forward it to a Philadelphia bank for collection. Generally, the draft would be a time draft requiring its presentation for acceptance. After acceptance, the Philadelphia bank would hold the draft (now a trade acceptance) and the bill as security for its advances on the St. Louis bank's account.

The arrangement was not novel, since ocean bills of lading had been used in much the same fashion in foreign trade.[94] To some extent, merchants used the documentary draft in the same way that

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Act, 1821, 1 & 2 Geo. 4, ch. 78, § 2. Promises made before the bill, therefore, can be enforced in England not as acceptances but as letters of credit. Megrah claims that the consideration controversy still poses a theoretical threat to the enforceability of letters of credit. See H. Gutteridge & M. Megrah, supra note 78, at 24-33. The American experience with virtual and extrinsic acceptances is consistent with Mansfield's view in *Pillans* that concerns of trade and commerce mandate the enforceability of promises to accept bills. Early in the 19th century, influential American jurists firmly stamped their approval on that view. See, e.g., Coolidge v. Payson, 15 U.S. (2 Wheat.) 66, 71-72 (1817) (Marshall, C.J.); Russel v. Wiggins, 21 F. Cas. 68, 73-77 (C.C.D. Mass. 1842) (No. 12,165) (Story, J.); Carnegie v. Morrison, 43 Mass. (2 Met.) 381, 388, 404-06 (1841) (Shaw, C.J.). Ultimately, American legislatures also outlawed the virtual and extrinsic acceptances. The Code shields the letter of credit from the English objections by rendering it enforceable without consideration. See U.C.C. §§ 3-410(1), 5-105; cf. Negotiable Instrument Law §§ 132, 134-135 (1896) (permitting extrinsic and virtual acceptances).

92 By the end of the 19th century, railroads had achieved considerable efficiencies with the negotiable through bill (a negotiable bill of lading issued by the carrier that received the goods and transported them on its own run and on that of connecting carriers to the destination). The device was helpful in the common "to arrive" contract that parties used in moving western agricultural commodities to market. See A. Chandler, The Visible Hand: The Managerial Revolution in American Business 211-12 (1977). Just as international trade was indispensable to the nation's economic growth during its early years, this internal movement of commodities was indispensable as the economy matured. See R. Higgs, The Transformation of the American Economy 1865-1914, at 79-106 (1971); D. North, The Economic Growth of the United States 1790-1860 (1961). Thus, it is all the more startling that in Shaw v. Railroad Co., 101 U.S. 557 (1879), the Court would be so oblivious to the true function of the negotiable bill.

93 This practice of attaching the bill of lading (a document of title) to the draft gave rise to the term "documentary draft." See U.C.C. § 4-104(1)(f). Note that in this discussion "bill" refers to the bill of lading and not the bill of exchange, which is now called the draft.

94 See Beutel, Colonial Sources of the Negotiable Instruments Law of the United States, 34 Ill. L. Rev. 137, 142-43 (1939).

banks used it, i.e., to avoid the need to investigate title. A Philadelphia merchant could buy the bill of lading and pay cash for it. In all cases the negotiability feature of both instruments (the draft and the bill of lading) was efficient because it permitted banks and traders to give credit in advance without concern as to adverse claims.

In *Shaw v. Railroad Co.*[95] the banker that presented the documentary draft to the Philadelphia buyer's agent for acceptance failed to notice that the agent removed the original bill of lading and substituted a duplicate when he returned the accepted draft. Armed with the original bill, the unscrupulous agent was then able to sell it to Miller, a second merchant, who surrendered it to the railroad in return for delivery of the cotton. He then sold the cotton through a broker to Shaw. In a replevin action for the cotton, Shaw set up Miller's good title,[96] and the Court correctly saw the issue as one of determining: (1) whether a negotiable bill of lading permitted a good faith purchaser to cut off prior claims (in this case that of the Philadelphia bank); and, if so, (2) whether Miller was a good faith purchaser.[97]

The jury found that Miller took with knowledge of facts that would lead him to know that the bill of lading was security for the bank.[98] The Court also found squarely that such knowledge deprived Miller of the good-faith-purchase protection of which Shaw was trying to avail himself.[99] The Court was not willing, however, to let the case rest on those grounds. Most of the opinion dealt with the nature of negotiability as it related to bills of lading. That discussion is revealing as it reflects the pattern evident in Lord Holt's campaign

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[95] 101 U.S. 557 (1879).

[96] The argument of Shaw, then, is a classic invocation of the shelter principle of conveyancing law. Shaw did not take by a negotiable document and could not, in his own right, cut off the bank's claim. Shaw took from Miller, however, and under the shelter principle, took whatever rights Miller had. If Miller could use the good-faith-purchase doctrine of negotiability to defeat the bank, Shaw would come within the shelter of Miller's protection. See, generally Dolan, The U.C.C. Framework: Conveyancing Principles and Property Interests, 59 B.U.L. Rev. 811, 812-13 (1979) (discussing the shelter principle and its application through the UCC).

[97] 101 U.S. at 562.

[98] Apparently, this finding resulted from a special interrogatory. Id. at 558-59. Shaw challenged the finding, but the Court would not upset it. The opinion unfortunately does not recite any of the facts relating to the charge that Miller should have known.

[99] Id. at 566. This part of the *Shaw* opinion, which constitutes its actual holding, is still the law. See U.C.C. §§ 1-201(19), (25), 7-501(4). Arguably, the balance of the opinion relating to the negotiability of bills of lading is dictum, see Beutel, supra note 94, at 145 n.72; but some courts read the case as holding that even the good faith purchase of a bill did not cut off prior claims, see Allen v. St. Louis Bank, 120 U.S. 20, 36 (1887); Robinson, McLeod & Co. v. Memphis & C. Ry., 9 F. 129, 136, 141-42 (W.D. Tenn. 1881); cf. National Bank of Commerce v. Chicago, B. & N.R.R., 44 Minn. 224, 236-37, 46 N.W. 342, 346 (1890) (similar rule).

against the note and in the acceptance cases: the *Shaw* Court fell back on old learning that hobbled the new merchant invention.

As the Court noted, the legislatures of Pennsylvania and Missouri had enacted statutes rendering the bill of lading negotiable. The Missouri provision, in language that is reminiscent of the Statute of Anne, rendered bills of lading negotiable "in the same manner as bills of exchange and promissory notes."[100] The Court felt that the term "negotiable" did not necessarily import the power to cut off prior claims, that feature being only one characteristic of negotiability. It might be enough to say that, since the law permits the transferee of the bill to sue in his own name, the bill is negotiable and the statutes are satisfied. The Court reasoned that extending the good-faith-purchase feature of negotiability to bills of lading depended upon the functions of the bill and the reason the law merchant accorded that treatment to drafts and promissory notes.

One cannot quarrel with the Court's premise, i.e., that the legislature's purpose in denominating a mercantile instrument "negotiable" is best served by investigating the use of the instrument. From that lofty premise, however, the *Shaw* Court tumbled to facile reasoning: drafts and notes needed the good-faith-purchase feature of negotiability because they served as currency; but bills of lading did not serve as currency, thus, they did not need it.[101]

The Court's reasoning is seriously flawed. The "currency" feature of drafts and notes effected efficient passage in the trade without title inquiry;[102] but the fact that bills did not serve as currency does not mean that they did not need to pass without the same facility. In fact, their marketing and financing functions were well served by the good-faith-purchase feature of negotiability, as the facts of the *Shaw* case demonstrate. The willingness of the St. Louis bank, the Philadelphia Bank, and the Philadelphia merchant to make advances against the bill of lading was directly related to its value. Full negotiability enhanced that value. If the bill of lading is negotiable, banks and traders generally do not need to investigate the title of the holder. The title risk, then, falls on the true owner of the bill and on the Philadelphia bank, which must guard against the thievery that was practiced by the agent. A holding of full negotiability puts the loss on the banker who through his own conduct failed to note the agent's

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[100] *Shaw*, 101 U.S. at 562 (emphasis omitted).

[101] Id. at 564-65.

[102] Since drafts and notes have now lost their function as currency, some advocate that they should lose their negotiability. See, e.g., Gilmore, Formalism and the Law of Negotiable Instruments, 13 Creighton L. Rev. 441, 454-58 (1979); Rosenthal, Negotiability—Who Needs It?, 71 Colum. L. Rev. 375, 377-81, 394-96 (1971).

sleight-of-hand substitution of the worthless duplicate for the original.[103] The *Shaw* opinion puts the loss on the Philadelphia merchant who, if he had taken in good faith and without notice, had no way of determining that the substitution had been effected. The fact is that the bank was in a far better position to guard against this risk than the merchant. The holder always is, and that is the reason we render these instruments negotiable.[104] Thus, a holding that gave full negotiability to the bill would have facilitated the financing and marketing of goods that moved by rail from the American interior either to American ports or manufacturing facilities.

The *Shaw* analysis is wrong, and even though the case did not unduly disturb the marketing and financing of transported goods,[105] the case stands as further evidence that courts have sometimes failed to perceive the commercial utility of merchant innovations.[106]

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103 The *Shaw* Court noted that the jury found the Philadelphia bank to be free from negligence. The bank may have behaved in a fashion that was reasonable compared with standards of the day, but the decision to impose liability on the bank, which I advocate, assumes that in relation to the conduct of the purchaser of the bill, the bank's conduct is the more blameworthy. Cf. William M'Ewan & Sons v. Smith, 9 Eng. Rep. 1109, 1117 (H.L. 1849) (criticizing a buyer under a nonnegotiable document of title for failing to protect its title as acting "with the utmost supineness"). (Sometimes it does no good to mince words.) A buyer takes a negotiable document precisely because he does not want to worry about title. See Phillips, The Commercial Culpability Scale, 92 Yale L.J. 228 (1982) (arguing that the risk should fall in this setting on the party best able to avoid it); Weinberg, Commercial Paper in Economic Theory and Legal History, 70 Ky. L.J. 567 (1981-1982) (defending the view that negotiability rules can be economically efficient).

104 Gilmore argued that in the last half of the 19th century, American courts rebelled against the doctrine of negotiability. Under his view, those courts rightly saw negotiability as valid only to the extent it served the currency function. They correctly concluded that financial institutions nurtured the doctrine as part of their efforts to force losses on their consumer borrowers that, in fairness, should have fallen on themselves. See Gilmore, supra note 102. That argument, however persuasive, loses force in the bill of lading transaction. Most of the time it is a merchant buyer, not a bank, that benefits from full negotiability of bills of lading. Banks do not deal in goods; traders do; and traders take the loss if the bill is bad. Banks stand to gain only when the buyer and seller default and, furthermore, can pass their losses on easily. If the bill is not negotiable, the bank can charge a higher discount. Even buying merchants can pass the risk to the seller by paying a lower price.

105 Although some courts followed the *Shaw* view, see cases cited supra note 99, other courts rejected it, see, e.g., Munroe v. Philadelphia Warehouse Co., 75 F. 545 (E.D. Pa. 1896); Sealy v. Missouri, Kan. & Tex. Ry., 84 Kan. 479, 114 P. 1077 (1911); Tiedman v. Knox, 53 Md. 612 (1880). By refusing to accept the negotiability of bills, the *Shaw* court reduced the efficiency of the marketing and financing transactions and thereby increased transaction costs to the benefit of no one.

Eventually, state legislatures rectified the bill of lading situation by adopting the Uniform Bills of Lading Act (1909), and Congress effected similar reform by enacting the Federal Bills of Lading Act in 1916. See 49 U.S.C. app. §§ 81-124 (1982). For discussion of the *Shaw* case and the effect of those statutes on it, see Justice Brandeis' opinion in Pere Marquette Ry. v. J.F. French & Co., 254 U.S. 538, 544 (1921).

106 It may be, as Gilmore claimed, that the doctrine of negotiability fell into some disfavor in the last part of the 19th century in cases involving promissory notes. See Gilmore, supra

VI. SOME CONCLUSIONS

The growth of the law is bound to be uneven, and it may suffice to explain the judicial failings abstracted here as instances of that unevenness. It is also plausible, however, that this history reflects an attitude. Judges are like the rest of us in sometimes failing to grasp new ideas. That failure is more pronounced, however—in the case of judges as well as everyone else—when the person confronting the innovation is predisposed against it. This judicial treatment of a number of merchant ideas may be indicative of that predisposition among some judges, and that indication may be reinforced by the hostility that is evident in some commentators on the law merchant.[107]

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note 102. Gilmore argued that in those cases lenders abused the doctrine, and he correctly observed that after the note had lost its currency function, good faith purchasers of notes were in a relatively better position to guard against defenses than were the makers to protect themselves from unscrupulous payees. The purpose of the good-faith-purchase doctrine is to protect the purchaser when he cannot protect himself. Thus, to use the doctrine of negotiability in those note cases was to stand the doctrine on its head. Although the codification of commercial law somewhat refurbished the negotiability of the note, see U.C.C. § 3-305; Negotiable Instruments Law § 57 (1896), administrative and legislative reform has largely destroyed it, see, e.g., Home Improvement Finance Act, Mich. Comp. Laws Ann. § 445.1207 (West Supp. 1985); Federal Trade Commission Holder-in-Due-Course Regulations, Preservation of Consumers' Claims and Defenses, 16 C.F.R. §§ 433.1-433.2 (1985). The case against the promissory note's negotiability should not be confused with the question of the bill of lading's negotiability. In the bill of lading transaction, the purchaser is not in a better position to protect against claims than its transferor. With the advent of open-account selling the negotiable bill lost its prominence in domestic trade. It retains that prominence in international sales, however, and the negotiable warehouse receipt continues to play a role in the marketing of goods domestically.

107 There is a body of literature that, taken together, leads one to conclude that the law merchant is a false myth nurtured by commercial interests. Implicit in much of this literature is the notion that when courts or legislatures propose laws that conflict with those commercial interests, they respond that the proposals are contrary to the law merchant. That is, it is implicit in the literature that merchants fashion a mythical law merchant to suit themselves and then appeal to their own product as if it were the semi-immutable *jus gentium*. It would be folly to deny that much of what these critics say is true, but it does not follow that merchants have no proper role in fashioning commercial law or that commercial law "is too important to be left to commercial lawyers," much less to commercial traders and bankers. See Danzig, A Comment on the Jurisprudence of the Uniform Commercial Code, 27 Stan. L. Rev. 621, 622-23 (1975). The problem may be one of definition; and while it is beyond the scope of this Article to discuss the matter, it is probably reasonable to say that the differences of Hart and Sacks on the one hand and Llewellyn on the other rest on their respective perceptions of what the law merchant is. It satisfies the test of this Article to say that merchant contributions to the law (merchant inventions) must withstand the rigors of common law analysis. But, the common law itself must not be rigid, and when merchant innovations prove fairer and more efficient than old common law rules, the old rules should go. By the same token, courts should not extend the application of old merchant rules to new situations and should not apply old rules to old devices that take on new roles, if such application is inconsistent with those same notions of fairness and efficiency. Gilmore may be correct when he decries use of the doctrine of negotiability in modern promissory note cases, given the fact that promissory notes have lost their function as currency. The legislatures and Federal Trade

Lord Holt is first. There are two plausible explanations for his campaign against the note. He may have objected to the doctrine of negotiability, viewing it as a merchant device to oppress the nonmerchant. Or he may have been Austinian in his view of the law, feeling that legal doctrine should emanate from the sovereign's judges and not from the bustling merchants with their international contacts and ideas. Neither of these explanations is entirely convincing, however. That he was opposed to negotiability is the less pursuasive. Holt recognized the negotiability of the bill of exchange and did not object to it. He gave the merchants a way to use the bill in much the way they were using the note, and he apparently participated in the drafting of the Statute of Anne that validated the note. This last fact supports the view that he was indeed a precursor to Austin in his view of the law, but his Austinianism does not explain the fact that he accepted the bill, a merchant invention, and rejected (after distinguishing it from the bill) the promissory note; nor does it explain his flash of temper and evident disdain for the goldsmiths. Lord Holt did not like the goldsmiths, and he was not going to sacrifice common law wisdom to their invention.

The later hostility of King's Bench and Exchequer courts to the virtual acceptance is puzzling to today's lawyer who so readily accepts the multiplicity of claims that common law judges and lawyers, until the time of Corbin and Gilmore, feared greatly. In an age of difficult communication and primitive recording systems, free alienation of incorporeal property prompted fears. The English courts that rejected the inventions merchants designed to strengthen their bills of exchange and to enhance international trade showed too little faith in the ability of merchants to fashion a practice that would work. In their efforts to protect the merchants from their own inventions, the English courts retarded commerce, though they eventually relented and made the English letter of credit a strong commercial device.

If Holt disdained the goldsmith in the promissory note cases and if the virtual acceptance cases display too little faith in merchants, the

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Commission may be correct as well when they outlaw the use of negotiable instruments in certain consumer transactions. See supra, note 106. That selective non-use of negotiability does not justify, however, the position that we discard the doctrine altogether any more than the misuse of the law merchant by banks should lead us to discard the law merchant. For a discussion of the theory that merchants abused the doctrine of negotiability to take advantage of nonmerchants, see M. Horwitz, supra note 42, at 212-26; Gilmore, supra note 102, at 452-61. For the view that banks used the law merchant to shift risks from themselves to their customers, see Scott, The Risk Fixers, 91 Harv. L. Rev. 737, 761-92 (1978). For early and recent instances of scholarly scepticism regarding the concept of the law merchant, see Ewart, What is the Law Merchant? 3 Colum. L. Rev. 135 (1903); Williams, The Search for Bases of Decision in Commercial Law: Llewellyn Redux (Book Review), 97 Harv. L. Rev. 1495 (1984).

Shaw decision ignores altogether the merchant need for a negotiable bill of lading. The *Shaw* Court may have been more concerned with its own power struggle with the legislature. It is no accident that the *Shaw* case is most often cited in support of the rule that statutes in derogation of the common law must be construed strictly.[108] The *Shaw* opinion demonstrates the shortsightedness of that rule in construing commercial statutes. Because the Court was not willing to defer to or did not understand merchant needs or because it did not care to find out what the merchant needs were, *Shaw* misconstrued the meaning of the term "negotiable" and restricted the effectiveness of the merchant innovation.[109] In *Shaw* the Supreme Court may have promoted concern for its own prerogatives over, in the Court's view, the less important concerns of those who were trying to market their goods.

The standby-letter-of-credit cases reflect a similar pattern. The merchants have devised a commercial innovation that speeds payment and shifts risks. In their haste to do what they think is fair and with insufficient regard for mercantile effect, the courts have hamstrung the innovation.

It is undoubtedly significant that in all of the controversies discussed here the merchant innovation is peculiarly "mercantile," i.e., it smacks of the law merchant and usually conflicts with common law norms. The doctrines of negotiability and the independence principle are first cousins. They respond to merchant needs for celerity in the marketplace and offend the slower-paced theories of common-law-conveyancing doctrine that grew out of real estate law. The bill of exchange, virtual acceptance, bill of lading, and letter of credit are, furthermore, not contracts, but commercial specialties to which the common law's contract rules are ill-suited.

In all of these cases, for the merchant invention to succeed in the

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108 "No statute is to be construed as altering the common law, farther than its words import. It is not to be construed as making any innovation upon the common law which it does not fairly express." Shaw v. Railroad Co., 101 U.S. 557, 565 (1879). The *Shaw* case was taken by some courts to be a leading case for the stated proposition. See, e.g., Wood v. White, 97 F.2d 646, 648 (D.C. Cir. 1938); Atchison, T. & S.F. Ry. v. Brotherhood of Locomotive Firemen, 26 F.2d 413, 418 (7th Cir. 1928). That feature of the *Shaw* opinion has been criticized as a subterfuge for judicial restriction of legislation. See G. Calabresi, A Common Law for the Age of Statutes 14-15 (1982); Pound, Common Law and Legislation, 21 Harv. L. Rev. 383 (1908).

109 Code drafters were wary of this judicial device for defeating legislative intent and attempted to forestall it by fashioning a contrary legislative command: "This Act shall be *liberally* construed and applied to promote its underlying purposes and policies." U.C.C. § 1-102(1) (emphasis added). Calabresi suggests that the "strictly construed" doctrine has fallen into disuse. G. Calabresi, supra note 108, at 15.

courts, judges must be willing to learn mercantile practices or to defer to the judgment of the merchants. The trouble these inventions encounter may be a consequence of the fact that some judges are not inclined to learn or defer. They want to make their own judgments, and they do so without acquainting themselves sufficiently with the practices involved. They may be too unwilling (as some of the commentators appear unwilling) to accept the notion that lawyers and judges can learn from bankers and traders, and even that bankers and traders can fashion wise legal doctrine. The failing is not new. It is the failing of analytical positivism—the notion that law is ordained by superiors to govern the conduct of inferiors.

This Article holds that that attitude has cost us much in commercial matters. The standby letter of credit is indeed the invention of the goldsmith's successors. It is a marvelous, efficient device; but it works successfully only in the light of the law merchant. It is on the independence principle that the success of the standby rests. If courts permit account parties to dilute the principle with fraud claims, the merchants will lose their latest invention.