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STANDBY CREDITS IN CANADA*

Gordon B. Graham** and Benjamin Geva***

Introduction

In recent years we have witnessed a substantial increase in the number of Canadian cases involving disputes as to the nature of the issuer's undertaking under a documentary letter of credit.¹ This coincided with a rapid growth in the use of the letter of credit as a standby credit facility in domestic and international transactions.^{1a} This article will examine the nature and scope of the issuer's undertaking under the standby letter of credit taking into account the various commercial uses and the types of disputes involved.

Part I will outline current uses of documentary letters of credit, identify the governing law and examine the legal basis for the

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¹ Since 1979, the reported cases are *Aspen Planners Ltd. v. Commerce Masonry & Forming Ltd.* (1979), 100 D.L.R. (3d) 546, 7 B.L.R. 102, 25 O.R. (2d) 167 (H.C.J.); *C.D.N. Research & Development Ltd. v. Bank of Nova Scotia* (1980), 18 C.P.C. 62 (Ont. H.C.J.); *Rosen v. Pullen* (1981), 126 D.L.R. (3d) 62, 16 B.L.R. 28 (Ont. H.C.J.); *Kanematsu-Gosho (Canada) Inc. v. Sinclair Supplies Ltd.* (1982), 16 B.L.R. 89, 37 A.R. 514 (Q.B., Master's Chambers); *C.D.N. Research and Development Ltd. v. Bank of Nova Scotia* (1982), 136 D.L.R. (3d) 656, 39 O.R. (2d) 13 (H.C.J. Div. Ct.), varg 122 D.L.R. (3d) 485, 32 O.R. (2d) 578 (H.C.J.); *Michael Doyle & Associates Ltd. v. Bank of Montreal* (1982), 140 D.L.R. (3d) 596, 19 B.L.R. 62, [1982] 6 W.W.R. 24 (B.C. S.C.); and *Henderson v. Canadian Imperial Bank of Commerce* (1982), 40 B.C.L.R. 318 (S.C., in Chambers); *Canadian Imperial Bank of Commerce v. Madill* (1983), 150 D.L.R. (3d) 417, 43 O.R. (2d) 1, 2 C.C.L.T. 75 (C.A.); *Canadian Pioneer Petroleum Inc. v. Federal Deposit Insurance Corp.*, [1984] 2 W.W.R. 563, 30 Sask. R. 315 (Q.B.).

^{1a} See in general, *infra*, text at footnotes 10-15.

issuer's liability to the beneficiary of the documentary credit. Part II will examine the principle of the autonomy of letters of credit and the fraud exception, particularly as applied by case law to the standby credit. The standard of compliance with documentary requirements does not raise issues specific to standby credits and will not be discussed. Part III will re-examine the autonomy principle, with particular emphasis on difficulties involved in application of the principle in light of the many uses of standby credits and possible disparity in the parties' intentions.

The ultimate goal of this article is to consider the effect the wide use of standby credits may have on letters of credit law, taking into account the commercial setting and policy considerations, and to present a comprehensive review of the principles of law governing the standby credit in Canada.²

I. The Documentary Credit: Its Uses, Nature and Binding Effect

A letter of credit is an engagement by one party (the "issuer"), normally a bank,³ made at the request of another party (the "applicant" or "account-party"), normally a customer of the bank, to the effect that the issuer will honour drafts or other demands for payment upon compliance with the conditions specified in the letter.⁴ In the case of a documentary letter of credit⁵ (hereafter "documentary credit", "credit" or "letter of credit"), a third party (the "beneficiary"), normally a creditor of

² Needless to say, the basic legal principles of letter of credit law are not Canadian made. Classic works presenting these general principles are Boris Kozolchuk, *Commercial Letters of Credit in The Americas: a comparative study of contemporary commercial transactions* (Albany, M. Bender, 1966); E.P. Ellinger, *Documentary Letters of Credit: a comparative study* (Singapore, University of Singapore Press, 1970); and H.C. Gutteridge and Maurice Megrah, *The Law of Bankers' Commercial Credits*, 6th ed. (London, Europa Publications, 1979). A recent Canadian overview is presented by Sarma, "Letters of Credit: Aspects of the Law and Practice" in L. Sarma, ed., *Corporate Structure Finance and Operations: essays on the law and business practice*, Vol. II (Toronto, Carswell Co. Ltd., 1982), p. 331.

³ Normally, but not necessarily. See e.g., *Kanetmatsu-Gosho (Canada) Inc. v. Sinclair Supplies Ltd.*, *supra*, footnote 1, dealing with a letter of credit issued by a company in connection with liability of its subsidiary. For letters of credit issued by non-bank financial institutions, see, *infra*, text preceding footnote 15a.

⁴ See e.g., *Wichita Eagle and Beacon Publishing Co., Inc. v. Pacific National Bank of San Francisco*, 493 F. 2d 1285 (9th Cir., 1974), revg 343 F. Supp. 332 (N.D. Cal., 1971).

⁵ The documentary credit is to be distinguished from the open letter of credit. The latter is designed to enable a merchant travelling overseas to raise funds. See in general Ellinger, *op. cit.*, footnote 2, at pp. 5-7.

the applicant, must make demand for payment upon the issuer by presenting a draft⁶ and the documents specified in the letter of credit.

The letter of credit traditionally has been used as a payment mechanism in the international sale of goods.⁷ A letter of credit so used (hereafter a "commercial letter of credit" or "commercial credit") is a promise by its issuer directly to the seller, made at the request of the buyer, to pay the purchase price of goods to the seller, or to accept a draft drawn by the seller for an equivalent amount. The pre-condition to payment or honour of the draft is simply that the shipping documents representing the goods and if applicable other relevant documents shall have been tendered to a bank (the issuing bank itself or a bank designated by it) on or before a specified date.⁸

The following example may be helpful. Suppose a Canadian buyer wants to import goods from Japan. The Japanese seller wants to be assured of payment after shipping the goods and delivering related documents of title. The buyer, however, will not risk payment in advance. A reasonable compromise is a contract for sale which calls for payment by letter of credit. The buyer-applicant is required to issue or "open" a letter of credit in favour of the seller-beneficiary. The Canadian bank will arrange for the "advising bank" to advise the seller of the arrangement. A convenient branch of the advising bank in Japan will be designated as the place where the seller will present the draft and shipping documents for acceptance or payment.

If the credit issued by the Canadian bank and advised to the seller by the Japanese bank is an "unconfirmed credit", the advising bank incurs no liability by merely notifying the beneficiary of the opening of the credit. However, if the seller is not satisfied with the promise of the Canadian bank it may insist upon an engagement by a local bank and the contract of sale will call for a confirmed credit. In such a case, the Canadian bank will ask

⁶ The draft is normally drawn on the issuer or a bank designated by the issuer, to the beneficiary's own order. No drafts are used in connection with a deferred payment credit (namely a credit under which payment is made after expiry of a stated period from presentation).

⁷ See *e.g.*, Harold J. Berman and Colin Kaufman, "The Law of International Commercial Transactions (*Les Mercantoria*)", 19 *Har. Int. L.J.* 221 (1978), at pp. 246-54.

⁸ See *e.g.*, Ellinger, "The Relationship Between Banker and Buyer Under Documentary Letters of Credit", 7 *U.W. Aust. L. Rev.* 40 (1966), at p. 40, note 1.

the Japanese bank (now a "confirming bank") to add its own undertaking to honour the credit on presentation of the documents. This added undertaking is known as a "confirmation", and the credit becomes a "confirmed credit". The confirmed credit gives the seller the advantage of a separate and additional payment commitment from a bank chosen by the seller.⁹

In recent years the documentary credit has been used increasingly as a security device in both international and domestic transactions. In this context it is known as a "standby credit" or "guarantee credit".¹⁰ Such a credit is not usually drawn upon if the underlying transaction runs smoothly. It resembles the traditional commercial credit in that it is issued by a bank at the request of a bank. It also involves an undertaking to make payment upon presentment of a document. Unlike the commercial credit, however, the standby credit involves payment by the issuer only if the bank customer fails to render payment or performance to the beneficiary.¹¹

An example of a typical transaction in which the standby credit is used domestically is a construction contract. The construction company may require the landowner to procure the issuance of a standby credit to ensure payment for a building. The letter of credit would provide that the bank would honour the construction company's draft when accompanied, for example,

⁹ In general, for the mechanism of commercial credit, the various arrangements and undertakings, see e.g., R.M. Goode, *Commercial Law* (Hammondsworth, Penguin Books, 1982), c. 24. See also David Smout, "The Finance of Overseas Sales", 19 *The Convey. (N.S.)* 33 (1955). For a Canadian perspective, see e.g., C.E. O'Connor, "Payment and Financing Mechanisms in International Trade and the Role of the Canadian Export Corporation", in J.S. Ziegel and W.C. Graham, eds., *New Dimensions in International Trade Law: A Canadian Perspective* (Toronto, Butterworths, 1982), at p. 58.

¹⁰ In general, for the standby credit, see e.g., Ellinger and J. Barry, "Standby Letters of Credit", 6 *Int. Bus. L.* 604 (1978), and Kozolchik, "The Emerging Law of Standby Letters of Credit and Bank Guarantees", 24 *Ariz. L. Rev.* 319 (1982). For the emergence of these devices as a by-product of the restrictions on American banks to issue guarantees, see Richard A. Lord, "The No Guarantee Rule and the Standby Letter of Credit Controversy", 96 *Ban. L.J.* 46 (1979).

¹¹ There has been a recent controversy in the United States as to whether the honouring of such a credit after the applicant's bankruptcy does not involve a voidable preference where the bank's right to reimbursement is secured by an interest in the applicant's property. See e.g., Douglas G. Baird, "Standby Letters of Credit in Bankruptcy", 49 *U. Chi. L. Rev.* 130 (1982); Kozolchik, *op. cit.*, footnote 10, at pp. 335-41; and Counsel's Corner, "Unscrewing Twistcap", 100 *Ban. L.J.* 636 (1983).

by an architect's certificate that the construction has progressed to a given stage of completion and a certificate given by the construction company itself that it had not been paid. In addition, the landowner might also require the construction company to procure the issuance of a standby credit to ensure completion of the building. This credit would be drawn upon by the landowner upon presenting the issuing bank with a draft accompanied by a declaration that the construction company had failed to perform its obligations under the construction contract.

Unlike the commercial credit, which is a payment device, the standby credit is primarily a security device and can be used to secure performance of the applicant's non-monetary obligations to the beneficiary. It is functionally similar to a performance or delivery bond.^{11a}

As noted by Professor Baird,¹² standby credits are often also used in connection with the domestic or international sale of goods to secure obligations other than payment of the purchase price. A supplier of raw materials would rather have a standby credit issued as the functional equivalent of payment than as a security interest in the goods themselves, since the costs associated with realization would render it an inadequate remedy. A buyer of manufactured goods might want protection for advances to suppliers to finance the purchase of raw materials. A satisfactory security in the raw materials would often not be feasible or available, but the letter of credit effectively secures the buyer against the supplier's bankruptcy or default. A seller of manufactured goods or commodities might also prefer a standby credit to a purchase money security interest in the goods if the risk of depreciation or price fluctuation cannot be offset by a short payment schedule. Finally, according to Professor Baird, a business that wishes to raise money may issue commercial paper backed by a standby letter of credit.

There has been remarkable growth in the use of standby letters

^{11a} A performance bond issued in favour of an obligee (buyer), guarantees the actual performance of the contract by the principal (seller) in accordance with its specified terms and conditions. In a case of a construction contract, the performance bond is issued in favour of the landowner and guarantees to him performance by the construction company. Performance bonds are issued in Canada by surety bond companies. A delivery bond is issued in connection with the sale of goods. It guarantees to the obligee the delivery of goods by the principal.

¹² *Op cit.*, footnote 11, at pp. 135-9.

of credit in Canada, particularly in the last five years. Standby credits have been used, *inter alia*, in the following situations:

- (a) as deposits (or in lieu of down payments) in sale of goods and investment transactions;
- (b) as prepayment of fees for services;
- (c) to secure undertakings under subdivision agreements;
- (d) to back the financial responsibility of developers;
- (e) to back warranties such as to the clearing of title defects or to the sufficiency of a fund;
- (f) to gear payments to the occurrence of events like progress in construction or planning approvals;
- (g) to support borrowings under international loans;
- (h) to ensure availability of supplies;
- (i) as performance guarantees in construction and other contracts; and
- (j) in project financing to spread completion, credit or regulatory approval risks.

According to Gordon Sedgwick,¹³ standby credits are commonly used in Canadian export transactions in three situations:

(a) in connection with the sale of capital goods by a Canadian seller to a foreign buyer to secure to the foreign buyer the return of a deposit or the reimbursement of an advance payment under the sale contract relating to the capital goods to be manufactured in Canada and delivered to the foreign country, in event of the failure of the Canadian seller to deliver the capital goods;

(b) in connection with contract tenders where the bid of a Canadian contractor is accepted and the contract is awarded to the Canadian contractor to deliver goods or perform services or both in the foreign country, to secure the foreign buyer in the event of the failure of the Canadian contractor to proceed with the contract awarded ... ;

(c) in connection with the contracts for the performance of services by a Canadian contractor in a foreign country or for the sale of goods and related services by a Canadian seller to a foreign country, to secure the foreign buyer or owner if the Canadian contractor or seller fails to perform the contract

Standby credits are also used in connection with counter-trade agreements.¹⁴ Under a counter-purchase contract, a Canadian

¹³ G.G. Sedgwick, "Aspects of Payment and Financing Mechanisms in the Export Trade" in *New Dimensions in International Trade Law*, *supra*, footnote 9, at pp. 87-8.

¹⁴ See *e.g.*, I. Feltham, "Countertrade: Barter of the Eighties", address to the Law Institute of the Pacific Rim, Toronto, September 14, 1983.

seller might undertake the purchase of goods from his foreign buyer. This undertaking could be given to induce the foreign buyer, concurrently, to enter into the principal contract for the purchase of the Canadian product. If the supply of the foreign goods to Canada were to be made over a long period, the foreign buyer (seller of the foreign goods) might require the Canadian seller (buyer of the foreign goods) to provide a standby credit. The credit would be drawn upon by the foreign party if his Canadian counterpart failed to purchase the foreign goods.

Recent case law in Canada also demonstrates that the standby credit can be used less conventionally. In *Rosen v. Pullen*,¹⁵ a standby credit was used in connection with a cohabitation agreement to ensure that the performance of one party would not go unrewarded.

In Canada, commercial credits usually are issued by banks. The international payment function requires a telecommunications and correspondence network that only banks seem to have. Standby credits also are most frequently issued in Canada by banks. However, the latter credits are also issued by others such as trust companies and major credit unions. In this regard, no significant discussion of possible regulatory issues has yet surfaced.

So far as banks are concerned, issuance of letters of credit is a traditional banking service and as such falls within the general banking power presently allowed under s. 173(1) of the Bank Act.^{15a} Other institutions issue credits under their general corporate powers and presumably view the amount of each credit as a loan asset and then, as applicable, ensure compliance with asset ratio tests or other regulatory constraints.

Documentary credits are usually, by express reference, made subject to the Uniform Customs and Practice for Documentary Credits ("UCP"). Banks in 165 countries adhere to these rules issued by the International Chamber of Commerce ("ICC"). The

¹⁵ *Supra*, footnote 1.

^{15a} S.C. 1980, c. C-40, s. 2. Section 173(1)(g) of the Bank Act provides that a bank's power to give a guarantee for payment of fixed sums of money is subject to any terms and conditions prescribed by regulation. The Act does not expressly deal with a bank's power to issue letters of credit. Unless it were judicially determined that a standby letter of credit is, at least for purposes of the statute, a guarantee, it seems the limitation of a bank's power to give a guarantee is not relevant. Provided issuance of a credit is in accordance with established practice, it will be within the scope of the general banking power conferred by s. 173(1).

current operational version is the 1974 Revision. A 1983 Revision is expected to come into operation on October 1, 1984.¹⁶ The 1983 Revision states that it applies "to all documentary credits, including ... standby letters of credit."¹⁷ The practice of incorporating the UCP into standby credits, which is common but not universal, preceded the drafting of the 1983 Revision.

Professor Goode states that "[t]he traditional view in England is that the UCP is simply a set of standard rules having no legal force except so far as incorporated by reference into the contract between the parties concerned."¹⁸ It thus follows that "so far as English law is concerned, the UCP is subordinate to legislation, may be excluded or restricted by contract, and if incorporated into the contract is, as a set of contractual terms, subject to the court's normal powers, at common law and by statute, to adjudicate upon the enforceability of contracted provisions."¹⁹ This is probably also true in Canada. Where the UCP is not expressly referred to in a letter of credit, the instrument will be governed by general principles of law and, in the case of commercial credits, by mercantile usage. Not surprisingly, to achieve this result the UCP itself might be taken as the best evidence of prevailing mercantile usage. In any event, the binding effect of the instrument is a matter to be determined under general principles of law.

In the United States, letters of credit are governed by Article 5 of the Uniform Commercial Code (hereafter "UCC Article 5").^{19a} However, New York State, a major international financial centre, has enacted a law excluding the application of UCC Article 5 to any letter of credit which by express agreement or course of dealing was subject to the UCP.²⁰

Letters of credit may be revocable or irrevocable. A revocable

¹⁶ For a historical overview, see Berman and Kaufman, *op. cit.*, footnote 7, at pp. 250-1. For the 1974 version see *e.g.*, Christopher S. Axworthy, "The Revision of the Uniform Customs on Documentary Credits", [1971] J. Bus. L. 38; and B.S. Wheble, "Uniform Customs and Practice for Documentary Credits (1974 Revision)", [1975] J. Bus. L. 281. For an update of the historical account and for the 1983 version, see Schmitthoff, "The New Uniform Customs for Letters of Credit", [1983] J. Bus. L. 193.

¹⁷ Article 1. All UCP cites in this article are from the 1983 Revision.

¹⁸ Goode, *op. cit.*, footnote 9, at p. 656.

¹⁹ Goode, *ibid.*, at pp. 657-8. *Cf.* Megrah, "Unfair Contract Terms Act, 1977", 2 Int. Ban. L. 74 (1983).

^{19a} See in general H. Harfield, *Letters of Credit* (1979).

²⁰ See Berman and Kaufman, *op. cit.*, footnote 7, at p. 251 and note 88.

credit may be cancelled by the issuer without notice, but of course cancellation does not affect rights already acquired by reliance, payment or acceptance prior to cancellation. An irrevocable credit, on the other hand, commits the issuer to honour the credit, notwithstanding contrary instructions by the customer, provided the terms of the credit are fulfilled by the beneficiary.²¹ The revocable credit will obviously be of little value as a security device. In practice it would be used simply as a payment mechanism where the beneficiary is not concerned with the credit worthiness of the applicant.²² It would be quite useless as a standby credit and accordingly careful note must be taken of the UCP which provides that, in the absence of an indication on the letter, a credit shall be deemed to be revocable.²³ Our principle concern in this article will thus be the more widely used irrevocable credit.²⁴

The effect of the documentary credit on the obligation for which it is given should be noted. In connection with the commercial credit, it has been held that "in the ordinary way, when the contract for sale stipulates for payment to be made by . . . irrevocable letter of credit, then, when the letter of credit is issued and accepted by the seller, it operates as conditional payment of the price. It does not operate as absolute payment."²⁵ Accordingly, "[i]f the letter of credit is honoured by the bank when the documents are presented to it, the [buyer's] debt is discharged. If it is not honoured the debt is not discharged; and the seller has a remedy in damages against both banker and buyer."²⁶ Presumably, the buyer's debt is revived at the expiry of the credit where no timely proper demand has been made. The

²¹ UCP Articles 7, 9 and 10.

²² See in general, Goode, *op. cit.*, footnote 9, at pp. 648-51.

²³ Article 7(c).

²⁴ See *e.g.*, *C.D.N. Research and Development Ltd. v. Bank of Nova Scotia*, *supra*, footnote 1, at pp. 659-60 D.L.R., pp. 16-17 O.R., where the court regarded the performance guarantee as irrevocable notwithstanding its silence on the point, and the contrary UCP rule as to such silence (see text which follows).

²⁵ *W.J. Alan & Co. Ltd. v. El Nasr Export and Import Co.*, [1972] 1 Lloyd's Rep. 313 at p. 323, [1972] 2 All E.R. 127 at p. 139 (C.A.), *per* Lord Denning.

²⁶ *Ibid.* *El Nasr* was followed in *Maran Road Saw Mill v. Austin Taylor & Co. Ltd.*, [1975] 1 Lloyd's Rep. 156 (Q.B. Com. Ct.). See also *E.D. & F. Man Ltd. v. Nigerian Sweets & Confectionery Co. Ltd.*, [1977] 2 Lloyd's Rep. 50 (Q.B. Com. Ct.). For an extensive discussion, see Malcolm Clarke, "Bankers' Commercial Credits Among the High Trees", [1974] Camb. L. J. 260 at pp. 269-76.

conditional payment rule is currently codified in the United States in UCC 2-325(2).²⁷

The conditional payment theory does not apply to standby credits. The standby credit is given as collateral security and not as a payment instrument. It is called upon only on the failure of the principal debtor, namely the applicant on the letter of credit.²⁸ Yet, whether as conditional payment or as collateral security, the documentary credit is not a guarantee of the applicant's undertaking towards the beneficiary. Rather, it is a separate and distinct undertaking of the issuer which is not dependent on the enforceability or content of the applicant's undertaking under his contract with the beneficiary. Unlike a guarantee which is a secondary and collateral undertaking dependent on the principal obligation, the documentary credit is a primary and independent obligation.²⁹ It depends alone on the presentment of documents and, even in the case of a standby credit, not on the default of the applicant.³⁰ The issuer's undertaking, not being dependent on any loss caused to the beneficiary, but rather on the presentment of documents, is also not an indemnity.³¹ It constitutes an engagement to pay upon tender of specified documents.

It seems universally accepted that, vis-à-vis the beneficiary,³² the issuance of the documentary credit binds the issuer, and confirmation binds the confirming bank, as soon as the opening of the credit is communicated to the beneficiary.³³ In the absence of a universally accepted third party beneficiary doctrine, however, the enforceability of the banker's undertaking in the beneficiary's hands remains theoretically obscure. It is difficult from a common law standpoint to identify consideration moving from the beneficiary.³⁴ The difficulty is that all relevant seller's obligations

²⁷ The Ontario Law Reform Commission ("O.L.R.C.") recommended that "the revised [Sale of Goods] Act incorporate a [comparable] provision". See O.L.R.C., *Report on Sale of Goods* (Toronto, Ontario Ministry of the Attorney-General, 1979), Vol. II, at p. 357, and s. 5.25(3) of the Draft Bill to Revise the Sale of Goods Act (Vol. III of the Report).

²⁸ See, *supra*, text at footnote 11.

²⁹ For the nature of the guarantee, see *e.g.*, Goode, *op. cit.*, footnote 9, at p. 875.

³⁰ The point is enlarged upon in Part II, *infra*.

³¹ For the nature of indemnity contract, see *e.g.*, Goode, *op. cit.*, footnote 9, at p. 875.

³² As well as vis-à-vis any negotiating bank (under a negotiation credit). For the theoretical basis of this liability, see *Re Agra and Masterman's Bank, Ex p. Asiatic Banking Corporation* (1867), L.R. 2 Ch. App. 391.

³³ See *e.g.*, Goode, *op. cit.*, footnote 9, at p. 658 and Gutteridge and Megrah, *op. cit.*, footnote 2, at p. 33.

³⁴ See *e.g.*, Gutteridge and Megrah, *ibid.*, at pp. 24-8. The buyer's duty to procure the

arise from the sale agreement and "the contract of sale is almost invariably made before the banker issues his credit, so that such consideration would be past."³⁵ The binding effect of the irrevocable credit as a separate contract vis-à-vis the beneficiary, can be explained only on the basis of mercantile usage³⁶ or by treating the irrevocable credit as a new type of mercantile currency embodying an abstract promise to pay independent of any actual agreement between payor and payee.³⁷ The failure to find an acceptable common law theory has not, however, resulted in serious doubt as to the enforceability of the credit by the beneficiary. The binding effect of the banker's undertaking vis-à-vis the beneficiary is thus axiomatic. It is inexplicable at common law and must be attributed to mercantile usage.³⁸

II. The Autonomy of the Letter of Credit

It is basic to letter of credit law that the credit be autonomous in relation to the contract between the account-party and beneficiary.³⁹ The issuer's engagement towards the beneficiary "is quite independent of the primary agreement between the [account] party and the beneficiary."⁴⁰ In connection with the commercial credit, the issuer's engagement "constitutes a [separate] bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to

irrevocable credit is an essential term of the contract for sale and not a condition precedent to the seller's obligation under the sale agreement. For an extensive discussion see Clarke, *op. cit.*, footnote 26, at pp. 264-9. Alternative common law theories are critically discussed by Gutteridge and Megrah, *op. cit.*, footnote 2, at pp. 28-33; Ellinger, *op. cit.*, footnote 2, at pp. 39-125; and Kozolchyk, *op. cit.*, footnote 2, at pp. 575-604.

³⁵ Gutteridge and Megrah, *op. cit.*, footnote 2, at p. 25.

³⁶ Ellinger, *op. cit.*, footnote 2, at p. 122.

³⁷ Kozolchyk, *op. cit.*, footnote 2, at p. 595; Goode, *op. cit.*, footnote 9, at p. 659.

³⁸ For a comprehensive discussion, see also G.W. Bartholomew, "Relations between Banker and Seller Under Irrevocable Letters of Credit", 5 McGill L.J. 89 (1959).

³⁹ See *e.g.*, Ellinger, *op. cit.*, footnote 8, at p. 47, and for an overview, B. Geva, "Contractual Defences as Claims to the Instrument: The Right to Block Payment on a Banker's Instrument", 58 Ore. L. Rev. 283 (1979), at pp. 288-92.

⁴⁰ See *Dulien Steel Products, Inc. of Washington v. Bankers Trust Co.*, 189 F. Supp. 922 (S.D.N.Y., 1960), at p. 927, *per* Bryan Dist. J., *affd* 298 F. 2d 836 (2d Cir., 1962), commented on by Ellinger in "The Autonomy of Letters of Credit", 4 Malaya L. Rev. 307 (1962). See also *Foreign Venture, Ltd. v. Chemical Bank*, 399 N.Y.S. 2d 114 (App. Div., 1977), at p. 116; *Kingdom of Sweden v. New York Trust Co.*, 96 N.Y.S. 2d 779 (S.C., 1949), at p. 791.

pay, irrespective of any dispute there may be between the parties as to whether the goods are up to [sic] contract or not."⁴¹

The independence of the issuer's engagement is the letter of credit's primary feature and distinguishes it from a guarantee which, in connection with credit used in a sales transaction, is secondary to the buyer's promise to pay the price.⁴² The absolute nature of the obligation is based on the terms of the letter of credit as agreed upon by the account-party and issuer and accepted by the beneficiary.⁴³ The characteristics of independence and absolute obligation are fundamental to the concept of letter of credit. Thus, "where ... the substantive provisions require the issuer to deal not simply in documents alone, but in facts relating to the performance of a separate contract ... all distinction between a letter of credit and an ordinary guaranty contract would be obliterated by regarding the instrument as a letter of credit."⁴⁴ The essence of the issuer's undertaking is the absolute promise of payment against the beneficiary's production of documents specified in the letter.

The autonomy of the letter of credit, shaped in cases dealing with commercial credits, has easily found its way to the standby credit. The landmark English case is *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.*⁴⁵ In this case, the undertaking of English suppliers to supply and install glass houses for Libyan customers was backed by an instrument called a performance guarantee. Notwithstanding its name, the instrument was held not to be a guarantee but rather a standby letter of credit.⁴⁶

⁴¹ *Hamzeh Malas & Sons v. British Imex Industries Ltd.*, [1958] 2 Q.B. 127 (C.A.), at p. 129, per Jenkins L.J. See also *Maurice O'Meara Co. v. National Park Bank of New York*, 146 N.E. 636 (N.Y.C.A., 1925), at p. 639: the issuer is concerned "only in the drafts and the documents accompanying them". The principle is known also as the abstraction of the credit promise. See Kozolchik, *op. cit.*, footnote 2, at p. 465.

⁴² Ellinger, *op. cit.*, footnote 8, at p. 47.

⁴³ See e.g., *Urquhart Lindsay and Co., Ltd. v. Eastern Bank, Ltd.*, [1922] 1 K.B. 318 at p. 323, per Rowlatt J.: by authorizing the issuer "to undertake to pay the amount of the invoice as presented", the buyer "is taken for the purposes of all questions between himself and his banker or between his banker and the seller to be content to accept the invoices of the seller as correct".

⁴⁴ See *Wichita Eagle and Beacon Publishing Co. Inc. v. Pacific National Bank of San Francisco*, *supra*, footnote 4, at p. 1286. Cf. *Davis O'Brien Lumber Co. Ltd. v. Bank of Montreal*, [1951] 3 D.L.R. 536, 28 M.P.R. 22 (N.B.S.C. App. Div.), where a narrow construction was given to a reference to the contract for sale in the letter of credit.

⁴⁵ [1977] 3 W.L.R. 764 (C.A.).

⁴⁶ Professor Goode classifies guarantees and performance bonds as a separate category

It provided that the Libyan buyers could draw on the credit by placing a simple demand with a Libyan bank. The Libyan bank's undertaking was backed by the undertaking of an English bank to pay it on first demand without any conditions or proof. On the facts of the case, "it appear[ed] that the English suppliers had not been in default at all. The only persons in default were the Libyan customers. . . . Yet the Libyan customers appear to have demanded payment from the [Libyan bank] on their guarantee. The [Libyan bank] then claimed on [the English bank] . . ." ⁴⁷

The English suppliers sought to enjoin the English bank from making payment on the performance guarantee. In disposing of the case, Lord Denning M.R. held that a "performance guarantee stands on a similar footing to a letter of credit."⁴⁸ He then added:

A bank which gives a performance guarantee must honour the guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions.⁴⁹

The English bank was thus allowed, and in fact required, to honour its obligation, in effect at the expense of the English suppliers. The suppliers were left with their breach of contract claim against the Libyan buyers.

Edward Owen was relied upon in an Ontario decision dealing with standby credits. In *Aspen Planners Ltd. v. Commerce Masonry & Forming Ltd.*⁵⁰ the plaintiff landowner entered into a building contract with the defendant contractor. To secure payment of its obligations to make progress payments, the plaintiff requested its bank to issue several irrevocable letters of credit to the contractor. Each letter provided that the bank would pay to the contractor the amount due, against receipt of a demand accompanied by a certificate of the contractor confirming

from standby credit. See Goode, *op. cit.*, footnote 9, at pp. 696-701. For our purposes this classification does not seem to be useful.

⁴⁷ *Supra*, footnote 45, at p. 770, *per* Lord Denning M.R.

⁴⁸ *Supra*, footnote 45, at p. 773.

⁴⁹ *Supra*, footnote 45, at p. 773. The fraud exception then referred to by Lord Denning is discussed in the text, *infra*, at footnotes 60-3.

⁵⁰ (1979), 100 D.L.R. (3d) 546, 7 B.L.R. 102, 25 O.R. (2d) 167 (H.C.J.).

that moneys drawn had been or would be expended pursuant to the building contract. The letter expressly provided that the issuer would honour such demands “ ‘without enquiring whether [the contractor had] a right as between [it] and [the landowner] to make such demand and without recognizing any claim of [the landowner].’ ”⁵¹

After the collapse of the building during construction but before the final certificates of entitlement were submitted to the bank by the contractor, the plaintiff brought an application for an interim injunction to restrain the contractor from making further drawings under the letters of credit and for an interim injunction to restrain the issuing bank from paying such draws. The application was dismissed. Quoting heavily from *Edward Owen*,⁵² Mr. Justice Henry could not find a basis for granting the injunctions. The bank could not be enjoined, since “[it was] obligated to pay the contractor under the letter of credit against a certificate that [was] not fraudulent to its knowledge,⁵³ regardless of any dispute between the plaintiff and the contractor under the building contract.”⁵⁴ It followed that “[it was] not within the [account-party’s] power to revoke or alter the terms of the letter of credit nor [was] the bank entitled to do so. The bank [could not] refuse payment at the instance of the [account-party]. Entitlement [was] a matter between the bank and the contractor.”⁵⁵

Henry J. further held that the plaintiff account-party could not enjoin the beneficiary from drawing on the letter of credit. Enjoining the contractor “from applying for and receiving a payment from the bank under the letter of credit — a transaction to which the plaintiff [account-party] is virtually a stranger,”^{55a} amounted, in Henry J.’s view, to “freezing a potential asset of the contractor as security to satisfy a potential judgment. In effect it is tantamount to execution before judgment.”⁵⁶ Under those circumstances, he did not “consider that such an interim injunction should issue.”⁵⁷

In result, the issuer’s engagement to the beneficiary was

⁵¹ *Ibid.*, at p. 548 D.L.R., p. 105 B.L.R.

⁵² *Supra*, footnote 45.

⁵³ The fraud exception is extensively discussed in text, *infra*, at footnotes 70-104.

⁵⁴ *Aspen Planners, supra*, footnote 50, at p. 551 D.L.R., p. 110 B.L.R., *per* Henry J.

⁵⁵ *Ibid.*

^{55a} *Ibid.*, at p. 552 D.L.R., p. 111 B.L.R.

⁵⁶ *Ibid.*

⁵⁷ *Ibid.*

regarded as being separate from, and autonomous in relation to, the construction contract between the account-party and the beneficiary. Claims and defences arising from the latter could not be raised in resisting a claim on the former.

The autonomy of the letter of credit is clearly reflected in the UCP. Under UCP Article 4, “[i]n credit operations, all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate.” It is the production of documents which entitles the beneficiary to payment.⁵⁸ The UCP also states that “[c]redits, by their nature, are separate transactions from the . . . contracts on which they may be based and banks are in no way concerned with or bound by such contracts.”⁵⁹

In support of the autonomy of the letter of credit, it is said that the “elaborate commercial system” of financing sales of goods by irrevocable credits “would break down completely if a dispute as between the vendor and the purchaser was to have the effect of ‘freezing’ . . . the sum in respect of which the letter of credit was opened.”⁶⁰ The irrevocable obligations assumed by banks under documentary credits are said to be “the life-blood of international commerce.”⁶¹ Underlying these observations are important factors including the large sums often involved in letter of credit transactions, the distance between the seller and buyer, and the use of the letter of credit as immediate collateral by the seller. In fact, the commercial credit is a payment mechanism designed to make the buyer’s payment contemporaneous with shipment of the goods by the seller. It is a means of shifting the credit strain to the buyer in case of a dispute.⁶²

Issuance of the credit could be viewed as analogous to delivering to the bank, in escrow, a bag of cash, to be delivered to the

⁵⁸ See also UCP Article 6:

A beneficiary in no case can avail himself of the contractual relationships existing between the banks or between the applicant for the credit and the issuing bank.

⁵⁹ Article 3. See also Article 16(b): the issuer’s determination to pay is to be made on the basis of documents alone; and Article 19: banks assume no responsibility for force majeure.

⁶⁰ *Hamzeh Malas & Sons v. British Imex Industries Ltd.*, *supra*, footnote 41, at p. 129.

⁶¹ *R.D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.*, [1977] 3 W.L.R. 752 (Q.B.), at p. 761, *per* Kerr J., quoted with approval in *Edward Owen*, *supra*, footnote 45, at p. 773.

⁶² See *e.g.*, Comment, “The Rights of the Seller Under a Documentary Letter of Credit”, 34 *Yale L.J.* 775 (1925), at p. 776.

seller in exchange for the shipping documents. The autonomy of the standby credit, however, cannot be based on the same analogy and might only be justifiable by reference to the parties' intentions. In this connection it is the parties' wish to use the documentary guarantee, rather than the surety bond, which invokes the autonomy of the banker's undertaking. This was clearly elaborated in *Aspen Planners*⁶³ where Henry J. had "much sympathy for the [account-party] who sees the possibility of obtaining an enforceable judgment disappearing."⁶⁴ However, he concluded, "that is the risk that [the account-party] took when [he] arranged the letter of credit with the bank."⁶⁵ It is clear therefore that it is the use of a particular instrument which imports the entire body of letter of credit doctrines and policies into the standby credit area.^{65a}

The autonomy of the letter of credit is not all-embracing. It is subject to a few narrow exceptions. One of them is forgery. When forged documents are presented by the beneficiary, the bank is entitled to refuse payment if it discovers the forgery before payment,⁶⁶ and it is entitled to recover the money from the beneficiary as paid under mistake of fact if it makes the discovery after payment. Yet forgery is not a real exception to the autonomy principle. Strictly speaking, forged documents do not comply with the terms of the credit,⁶⁷ and their tender should not entitle the beneficiary to obtain payment.

The autonomy of the letter of credit also does not enable parties to contravene public policy or circumvent a statutory or regulatory scheme. Thus, for example, under s. 12(3) of the Conditional Sales Act of Newfoundland,⁶⁸ where a conditional seller repossesses goods from the defaulting buyer,

⁶³ *Supra*, footnote 50.

⁶⁴ *Supra*, footnote 50, at p. 552 D.L.R., p. 111 B.L.R.

⁶⁵ *Supra*, footnote 50, at p. 552 D.L.R., pp. 111-12 B.L.R. See also *American Bell International Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D. N.Y., 1979), at p. 426, where the court spoke of the account-party "knowingly and voluntarily [signing] a contract allowing the Iranian government to recoup its downpayment on demand, without regard to cause".

^{65a} This point is elaborated and critically discussed, *infra*, in Part III.

⁶⁶ See e.g., *Bank Russo-Iran v. Gordon, Woodroffe & Co. Ltd.* (October 3, 1972), as quoted in *Edward Owen, supra*, footnote 45, at p. 772.

⁶⁷ But note the difference which is said to exist between the tender of documents by the beneficiary and their tender by any other holder of the draft: see Gutteridge and Megrah, *op. cit.*, footnote 2, at pp. 140-1. Only in the former case is the law consistent with the view that the forged documents are non-conforming.

⁶⁸ R.S. N. 1970, c. 56, as amended.

(3) ... his right is restricted to repossession and sale of the goods and any claim by him for the unpaid purchase price is by reason of the retaking of possession and sale fully paid and satisfied.

No waiver of this provision can be made even by a corporate buyer.⁶⁹ Since the effect of repossession and resale is to constitute full payment and satisfaction, this provision seems to foreclose recovery against the buyer's guarantor.

If a seller secured a possible claim to a deficiency by requiring the buyer to provide a standby credit to be called on demand by the seller after repossession and resale of the goods, it appears possible that the seller may recover his shortfall. The statutory defence available to the buyer against the seller would seem to be unavailable to a bank because the autonomy principle is an answer to the seller's demand on the letter of credit. The buyer would be obliged to pay the bank, not under his obligation under the contract of sale, which has been extinguished, but rather on his reimbursement undertaking as account-party in connection with issuance of the letter of credit. However, it seems to us more likely that a court would view the use of the documentary credit under such circumstances as a scheme to avoid the protection afforded by statute and that such a letter of credit would be unenforceable on public policy grounds.⁷⁰

A well-established exception to the autonomy of the letter of credit is fraud. The landmark case is *Sztejn v. J. Henry Schroder Banking Corporation*.⁷¹ In that case, the plaintiff account-party brought an action to restrain the payment of drafts under a commercial credit. He alleged that the seller delivered worthless material instead of the contract goods. Acknowledging the autonomy of the letter of credit, the court granted the injunction and stated:

This is not a controversy between the buyer and seller concerning a mere

⁶⁹ Corporate waivers with respect to similar statutory provisions are permitted in British Columbia, Sale of Goods on Condition Act, R.S.B.C. 1979, c. 373, as amended, s. 19; Alberta, Law of Property Act, R.S.A. 1980, c. L-8, s. 49; and Saskatchewan, Limitation of Civil Rights Act, R.S.S. 1978, c. L-16, as amended, s. 40.

⁷⁰ In this context, compare to some American case law. One case allowed an issuing bank to defend an action on a letter of credit obligating it to lend a sum of money greater than that permitted by the applicable loan limit statute. Another held that an issuing bank was not estopped from invoking a state statute setting a one-year limit on a letter of obligations. See Counsel's Corner, "Sztenjing (Steining) The Letter of Credit: More Strings for the Bow", 93 Ban. L.J. 954 (1976).

⁷¹ 31 N.Y.S. 2d 631 (S.C., 1941).

breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.⁷²

The fraud exception is thus a rule of public policy that "must be narrowly limited to situations . . . in which the wrongdoing . . . has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served."⁷³ Accordingly, fraud must be egregious, clearly supported by the evidence, and not merely alleged.⁷⁴ It must be "intentional" or "active" and limited to circumstances "where the merchandise is not merely inferior in quality but consists of worthless rubbish."⁷⁵ The fraud exception should thus not be applicable to an improper demand made after a breach of warranty relating to the quality of the goods.⁷⁶

A doctrinal rationale for the fraud exception was advanced by Mr. Justice Cardozo even prior to *Sztejn*. "Worthless rubbish" supplied in lieu of contract merchandise is an instance of total failure of consideration. This failure of consideration is also a matter between the seller and the bank. Thus, according to

⁷² *Ibid.*, at p. 634, per Shientag J.

⁷³ See *Intraworld Industries, Inc. v. Girard Trust Bank*, 336 A. 2d 316 (Pa. S.C., 1975), at pp. 324-5, per Roberts J.

⁷⁴ See in general, Henry Harfield, "Enjoining Letter of Credit Transactions", 95 Ban. L.J. 596 (1978). For a recent case, see e.g., *Colorado National Bank of Denver v. Board of County Commissioners of Routt County*, 31 U.C.C. Rep. Ser. 1681 (Colo. S.C., 1981), at p. 1691.

⁷⁵ *Sztejn*, *supra*, footnote 71, at p. 635. For a recent case supporting the "intentional fraud" test, see *West Virginia Housing Development Fund v. Sroka*, 415 F. Supp. 1107 (W.D. Pa., 1976).

⁷⁶ *Sztejn*, *supra*, footnote 71, at p. 635. See also H. Finkelstein, *Legal Aspects of Commercial Letters of Credit* (New York, Columbia University Press, 1930), p. 248. But see *NMC Enterprises, Inc. v. Columbia Broadcasting System, Inc.*, 14 U.C.C. Rep. Ser. 1427 (N.Y. S.C., 1974), where the seller's fraudulent warranty formed the ground for an injunctive relief against the issuer. The case is criticized convincingly, together with other recent deviations from the autonomy of letters of credit, by Justice B. Jack in "Letters of Credit: Expectations and Frustrations — Part 2", 94 Ban. L.J. 493 (1977), at pp. 502-3. For cases suggesting an alternative "flexible standard" for determining fraud (e.g., *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 392 N.Y.S. 2d 265 (1976), at p. 271) or that fraud must not necessarily be intentional (e.g., *Dynamics Corporation of America v. Citizens and Southern National Bank*, 356 F. Supp. 991 (N.D. Ga., 1973), at p. 998), see Note, "Letters of Credit: Injunction As a Remedy for Fraud in U.C.C. Section 5-114", 63 Minn. L. Rev. 487 (1979), at pp. 497-500.

Cardozo J.'s dissent in *Maurice O'Meara Co. v. National Park Bank of New York*,⁷⁷ the issuing bank which advances money upon a commercial letter of credit "acts not merely upon the credit of its customer, but upon the credit also of the merchandise which is to be tendered as security."⁷⁸ Having misrepresented "the security upon which advances are demanded,"⁷⁹ the seller should not be entitled to these advances. This view was echoed in *Sztejn* where the court acknowledged that "in the issuance of the letter of credit ... the security afforded by the merchandise is also taken into account."⁸⁰

There are, however, a few difficulties with this analysis. To begin with, total failure of consideration may arise in situations not involving fraud, as for example, where the wrong merchandise was mistakenly shipped to the buyer. Hence, the fraud exception contemplates total failure of consideration on the basis of totally worthless goods.⁸¹ Secondly, the reality is that the bank does not rely substantially on the security of the goods. In Canada, credit is extended to the buyer under the documentary credit on the basis that the bank's contingent liability is within the bank customer's over-all line of approved credit. Thirdly, the very existence of beneficiary's warranties, running in favour of the issuer as to the quality of the goods, is a very dangerous opening which may easily be extended to cases other than cases involving total failure of consideration. Finally, the theory does not work in connection with the standby credit where the documents do not represent title to goods and therefore do not constitute security in the banker's hands.⁸² Nevertheless, the concept of total failure of consideration would appear to be valid,

⁷⁷ 146 N.E. 636 (N.Y.C.A., 1925).

⁷⁸ *Ibid.*, at p. 641, *per* McLaughlin J.

⁷⁹ *Ibid.*

⁸⁰ *Supra*, footnote 71, at p. 635. For a recent review of *Sztejn* and related issues, see Turcotte, "Duty to Honour Drafts under a Letter of Credit", 2 Natl. Ban. L. Rev. 84 (1983), at pp. 87-9.

⁸¹ See *e.g.*, Ellinger, "The Tender of Fraudulent Documents Under Documentary Letters of Credit", 7 Malaya L. Rev. 24 (1965), at p. 38, where he suggests that *Sztejn* applies only where "[t]he facts . . . speak for themselves". Thus, "[t]he description of old, worthless, newspapers as 'class I typing paper' is inconsistent with anything but a fraud. But, if the goods shipped are not altogether worthless, the banker should be advised not to rely on the fraud rule."

⁸² The difficulties in fitting the fraud exception to the standby credit transaction are clearly demonstrated in *American Bell International, Inc. v. Islamic Republic of Iran*, *supra*, footnote 65.

at least in connection with the commercial credit. In so far as it is based on the relationship between the issuer and the beneficiary and on the beneficiary's misrepresentation as to the documents, the analysis does not undermine, in theory at least, the autonomy of the letter of credit.⁸³

There is, however, another difficulty with Cardozo's analysis that seems to undermine it altogether. In *Sztejn*, as in most cases, it was the issuing bank which wanted to pay and the applicant who wanted to block payment. Normally, in the case of a letter of credit dispute, the applicant's bank branch will be inclined to support the customer or at least to assist him. This attitude stems partly from the nature of the banker-customer relationship and partly from the fact that payment for an account-party who did not obtain performances from the beneficiary may put the account-party (the bank's customer) into serious financial difficulties. Depending on the amount of the credit, the banker might be truly concerned with its security or with the customer's solvency. In the final analysis, however, in making its decision to pay, the bank takes into account the interests of its international department concerning the integrity of the letter of credit device generally and the international reputation of the bank. These factors tend to outweigh all other considerations. Since the banker wants to pay, the theory of the breach of the beneficiary's warranty running in favour of the banker as a defence to the banker, is divorced from the reality. Indeed, in applying the fraud exception courts purport to protect the beneficiary, not the banker. To base this protection on a warranty running from the beneficiary to the bank is, in a relationship to which the applicant is technically a stranger, quite inconsistent with basic principles.

Sztejn has been cited with approval by several English courts.⁸⁴ So far, it has never been followed by them. The standard adhered to in these cases was "established or obvious fraud",⁸⁵ or "a clear fraud,"⁸⁶ none of which has ever been found in any decided case.

⁸³ In this respect there is no real distinction between "fraud in the documents" and "fraud in the transaction" (referred to in UCC 5-114(2)), since the latter is reflected in a misrepresentation as to the accuracy of the documents.

⁸⁴ See e.g., *Discount Records Ltd. v. Barclays Bank Ltd.*, [1975] 1 W.L.R. 315 (Ch.), at pp. 318-19; *R.D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd.*, [1977] 3 W.L.R. 752 (Q.B.), at p. 762; *Edward Owen Engineering Ltd. v Barclays Bank International Ltd.*, [1977] 3 W.L.R. 764 (C.A.), at p. 771.

⁸⁵ *Edward Owen*, *ibid.*

⁸⁶ *Ibid.*, at p. 773.

Thus, in *Discount Records Ltd. v. Barclays Bank Ltd.*,⁸⁷ the buyer sought an injunction against the paying bank to restrain payment on the basis of shortfall in delivery, the delivery of defective goods, and the fraudulent alteration of serial numbers. The application was dismissed since mere allegation of fraud is not sufficient to invoke the injunctive relief. In *Edward Owen*, Lord Denning acknowledged breach of contract by the beneficiary⁸⁸ but could not find evidence to support a clear fraud.

The most recent high authority is the decision of the House of Lords in *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*.⁸⁹ In this case, the confirming bank refused to honour the credit since the bills of lading were fraudulently backdated by the loading broker without the knowledge of the beneficiary. The backdating was made to give the appearance of compliance with the terms of the credit. Citing *Sztejn*, as approved in *Edward Owen*, Lord Diplock acknowledged the existence of the fraud exception, but found it limited to material fraudulent misrepresentations of fact by the beneficiary in presenting the documents to the issuing or confirming bank. As such, the exception was inapplicable to the facts of the case and the court stated:

The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or . . . "fraud unravels all." The courts will not allow their process to be used by a dishonest person to carry out a fraud.⁹⁰

On the facts of the case, fraud was neither committed by, nor known to, the beneficiary and consequently the fraud exception did not apply. Lord Diplock left open the question of forgery of a document of which the beneficiary was not aware.

The decision was characterized as representing "the high water mark of the principle of autonomy of the documentary credit."⁹¹ Its holding is consistent with the view that bases the fraud exception on the misrepresentation of the beneficiary towards the bank as to the content of the documents. But the decision was based on total failure of consideration rather than fraudulent misrepresentation. In circumstances in which the facts speak for

⁸⁷ *Supra*, footnote 84.

⁸⁸ See, *supra*, text at footnote 47.

⁸⁹ [1982] 2 W.L.R. 1039 (H.L.).

⁹⁰ *Ibid.*, at p. 1045, *per* Diplock L.J.

⁹¹ Clive M. Schmitthoff, "Export Trade", [1983] J. Bus. L. 319 at p. 321.

themselves, total failure of consideration is a mere example of fraud; it does not exhaust the entire principle. The key is, none the less, fraud of the beneficiary on the issuer and not on the account-party.

Compared to their English counterparts, Canadian courts have been less hesitant to invoke the fraud exception. On one hand, courts in Canada have adhered to the distinction between commercial disputes and fraud, and refused to disregard the autonomy of the letter of credit as to the former cases. Thus, in *Aspen Planners*,^{91a} Henry J. viewed the account-party's claim against the contractor based on the collapse of the building as a commercial dispute. Under these facts there was no fraud on the contractor's part in demanding payment.⁹² Likewise, in *C.D.N. Research and Development Ltd. v. Bank of Nova Scotia*⁹³ (hereafter the "Iraq case") the court found that demand made on a standby credit designed to secure the supply of goods was not fraudulent. The goods were not supplied by the account-party seller, which claimed fundamental breach on the beneficiary-buyer's part. In the court's view, this was precisely the type of commercial dispute that could not be invoked in connection with the engagement on the letter of credit. The court relied on *Edward Owen* but seemed to prefer the test of "prima facie case of fraud" over Lord Denning's "clear fraud."⁹⁴ Since even a prima facie case of fraud was not shown, no injunction was granted.

On the other hand, in an earlier case between the same parties (the "Iran case")⁹⁵ on another standby credit, Galligan J. did grant an injunction. The facts were quite similar to the *Iraq* case, with one major difference: the goods were, in fact, supplied to the buyer. Accordingly, "the plaintiff [account-party-seller had] established . . . a good prima facie case of fraud on the part of the [beneficiary-buyer]."⁹⁶ As was subsequently explained in the *Iraq* case, "[t]he demand [in the *Iran* case] was fraudulent . . . because

^{91a} *Supra*, footnote 50.

⁹² See in general, *supra*, text at footnotes 50-7.

⁹³ (1982), 136 D.L.R. (3d) 656, 39 O.R. (2d) 13 (H.C.J. Div. Ct.), varg 122 D.L.R. (3d) 485, 32 O.R. (2d) 578 (H.C.J.).

⁹⁴ *Ibid.*, at p. 662 D.L.R., p. 19 O.R.

⁹⁵ *C.D.N. Research & Development Ltd. v. Bank of Nova Scotia* (1980), 18 C.P.C. 62 (Ont. H.C.J.).

⁹⁶ *Ibid.*, at p. 65.

delivery of the goods had clearly been made and yet the call was on the basis of non-delivery."⁹⁷

The fraud exception was next applied in *Rosen v. Pullen*.⁹⁸ The case involved a standby letter of credit issued in connection with the financial aspects of a cohabitation agreement. A man procured the issuance of the letter of credit in a woman's favour, on the understanding that she would not call on the letter unless certain conditions were satisfied. These conditions were not reflected in the terms of the credit. The woman called on the letter even though the conditions had not been satisfied. The court concluded that once it was shown that, as toward the account-party, the beneficiary was not entitled to call on the credit, a *prima facie* case of fraud had been established.

A recent reported case involving the application of the fraud exception is *Henderson v. Canadian Imperial Bank of Commerce*.⁹⁹ In that case, the plaintiff account-party arranged for the issue of a standby credit in connection with his undertaking to pay the purchase price of units of entitlement in television shows. The shows were never produced and after the insolvency of the beneficiary its receiver demanded payment under the letter of credit. The account-party sought an interim injunction to stop the bank from making payment. The application was granted. The court followed *Rosen v. Pullen* and specifically disapproved of *United City Merchants*. In the opinion of Berger J., "[t]he exception based on fraud, as that conception is understood in equity, has been thus broadened, and the case at bar falls within it."¹⁰⁰ Calling on a credit with knowledge of lack of entitlement constitutes fraud and does not entitle the beneficiary to payment.

All three cases, the *Iran* case, *Rosen v. Pullen* and *Henderson* (hereafter the "injunction cases"), represent an unwarranted intrusion into the documentary nature of the credit. The beneficiary under each letter of credit was not required to state that the pre-conditions were fulfilled and, therefore, no fraudulent document was submitted by him. All three cases seem to replace a "fraudulent document" with a "fraudulent demand" requirement; if their logic is to be pursued, every wrongful demand by a

⁹⁷ *Supra*, footnote 93, at p. 662 D.L.R., p. 19 O.R., *per* Smith J.

⁹⁸ (1981), 126 D.L.R. (3d) 62, 16 B.L.R. 28 (Ont. H.C.J.).

⁹⁹ (1982), 40 B.C.L.R. 318 (S.C. in Chambers).

¹⁰⁰ *Ibid.*, at p. 320.

breaching party is fraudulent. This seems to undermine the whole concept of the autonomy of the letter of credit.

It should be emphasized, however, that each of the three injunction cases involved an interlocutory injunction. Interlocutory injunction cases may be decided summarily, and sometimes without the court having sufficient time or instruction to allow reflection and well-reasoned decisions. Many unreported interlocutory injunction cases have been brought to our attention and do not follow the same direction as the reported cases. It is impossible therefore to draw firm conclusions on the basis of the three reported cases as to a likely direction the law may take. In addition, at the time of this writing, a trial on the merits in *Henderson* is pending, counsel having concluded that the matter was too important to be left to an appeal of the interlocutory application itself. The three cases should not be overlooked, however, as a threat to the integrity of the autonomy principle.

In fact, all three injunction cases reflect the difficulties involved in fitting the standby credit into the legal framework developed for the commercial credit. *Sztejn* dealt with the obvious case of "worthless rubbish" being supplied instead of the contracted goods, as well as the procurement of fraudulent documents to induce payment. It is likely that the applicant, having intended that the timing of payment on the documentary credit would coincide with tender of the shipping documents, never intended to assume the risk that the contracted goods would not be shipped. This should be contrasted with the situation in all three injunction cases where the very issuance of the letter of credit created the risk, clearly assumed by the applicant, of a call by the beneficiary notwithstanding non-fulfilment of related conditions precedent in the underlying contract between the account-party and beneficiary. Furthermore, in *Henderson*, it is very likely that issuance of the letter of credit was, and was perceived to be, in lieu of cash payment, and that the parties chose the letter of credit alternative simply as an efficient financing technique during a period of high interest rates. By enjoining payment, the court in effect gave the applicant the equivalent of a security interest in the insolvent beneficiary's assets. Not having bargained for this, the applicant may thus have obtained a windfall at the expense of other unsecured creditors.

In the final analysis, the autonomy of the letter of credit certainly should not be interfered with except in circumstances

where its existence frustrates the original expectations of the parties and arguably not even then. In this respect, *United City Merchants* can be misleading. The facts of the case were peculiar. There the backdating of the document was fraud perpetrated directly against the issuer. The court, however, was not able to find fraudulent misrepresentation by the beneficiary. The fact situations involved in the three reported injunction cases, however, were concerned with fraud alleged to have been directed primarily at the applicant. In that context, the parties' objective expectations should perhaps have determined the autonomy issue. As it dealt with quite different facts, *United City Merchants* should not be taken to provide guidance. As for the three injunction cases, the parties' expectations unfortunately played no role in the decisions.

It is noteworthy that an interim *ex parte* injunction allocates the initial credit strain to the beneficiary. Furthermore, the scope of the fraud exception is primarily a matter of law. If any call by a breaching party constitutes fraud, the final outcome of the litigation on the issuer's liability will not be different than the one reached at the early interim injunction stage.

A remaining question in Canadian jurisprudence is the position of the issuing bank which knows of the fraud but is not restrained by an injunction. May it refuse to pay? Does it pay at its peril?

The matter is dealt with in UCC Article 5 in an equivocal manner. Under UCC 5-114(2)(b), in the case of fraud, "an issuer acting in good faith may honor the . . . demand for payment despite notification from the customer of fraud . . . but a court of appropriate jurisdiction may enjoin such honor." Hence, in the absence of an injunction, the issuer "acting in good faith" may honour the credit despite knowledge of the fraud. The section is contradictory since it is not clear how a bank which knows of fraud may be said to pay in good faith. Perhaps the distinction is between notification of the fraud by the customer, and the bank's knowledge of the fraud. In the former case, where the bank is notified but is not convinced of the correctness of the allegation, it might honour the credit unless it is enjoined from doing so. Yet, it is unreasonable to expect the bank to know of the fraud, or be convinced that it exists. At the most, the bank knows of its customer's complaint as to the fraud. Hence, the test of UCC 5-114(2) appears to be quite illusory.¹⁰¹

In *United City Merchants*¹⁰² the underlying assumption clearly was that the bank should not pay in the face of knowledge of the beneficiary's fraud.¹⁰³ A recent Quebec Court of Appeal decision is to the same effect.¹⁰⁴ It is submitted, however, that this rule is not responsive to sound policy considerations. The bank cannot be expected to determine the existence of fraud. The better view would be to give the bank the discretion to withhold payment at its peril, but at the same time the duty to give a concerned customer a reasonable time to obtain an injunction. In practice, it is not uncommon for a bank to discuss the benefit of obtaining an injunction with its customer, and to allow a short period of time for it to be obtained. The bank cannot be forced to withhold funds unduly, however, only because it knows that the account-party claims fraud.

III. Parties' Intentions and the Autonomy Principle

It was stated earlier that invocation of the autonomy principle in standby letters of credit can only be justified by reference to the intention of the parties, and that it is their wish to use the documentary credit which invokes the autonomy of the banker's undertaking.¹⁰⁵ The basis of ascertaining this intention will now be examined. The discussion will necessitate some re-examination of the autonomy principle as applied to the standby credit.

The starting point is the language of the letter of credit itself. Where autonomy is intended, the letter should indicate that it is governed by the UCP. This is not to suggest that there should be permitted a class of letters of credit, standby or not, which would not be autonomous because they do not adopt the UCP. Rather, we suggest simply that it will be prudent to evidence the intention

¹⁰¹ For a critique on the elective dishonour, see *e.g.*, Note, *supra*, footnote 76, at pp. 508-16.

¹⁰² *Supra*, footnote 89.

¹⁰³ This was not an injunction case. The bank refused to pay and the issue was whether this was proper in the absence of the beneficiary's own fraud.

¹⁰⁴ *Angelica-Whitewear Ltd. and Angelica Corp. v. The Bank of Nova Scotia* (March 3, 1983, Que. C.A.), discussed by Turcotte, *op. cit.*, footnote 80, at pp. 88-9. "The matter is now before the Supreme Court of Canada": see Turcotte, *ibid.*, at p. 89.

¹⁰⁵ See, *supra*, text preceding footnote 63.

that an instrument is, in fact, intended to be a letter of credit so that application of the autonomy principle will follow automatically. The practice of expressly adopting the UCP may become particularly important under the 1983 Revision, in which standby credits will be referred to expressly, and in connection with the increasing occurrence of the issuance of letters of credit by non-banks. In the former case, failure to adopt the 1983 Revision by express reference could bear the inference that the relative instrument was not perceived by the parties to be a letter of credit, at least if other circumstances, such as reference to the instrument as a guarantee or performance bond, also supported such a conclusion. In the case of issuance of the instrument by a non-bank financial institution which customarily or historically did not issue letters of credit, the reference to the UCP would eliminate concern as to the parties' intention. The instrument should not be entitled "letter of guarantee" or anything else that might suggest the parties intended a relationship different from that of issuer and beneficiary.

It could well be that in *Edward Owen*,¹⁰⁶ Lord Denning was too eager to conclude that a "performance guarantee stands on a similar footing to a letter of credit."¹⁰⁷ No evidence of applicable mercantile usage was introduced in that case. However, the risk of characterizing a letter of credit as a guarantee could be minimized by eliminating terminology and terms associated with other devices. As for the conditions which call for the issuer's duty to pay, pure demand language might prove counter-productive. Courts might consider that the obligation to pay on simple demand would implicitly be subject to certain pre-conditions being satisfied. From a drafting standpoint, detailed language seems to be more prudent. For example, in *Aspen Planners*,¹⁰⁸ the issuer expressly agreed to honour demands accompanied by completion certificates "without enquiring whether [the beneficiary had] a right as between [himself] and [the account-party] to make such demand and without recognizing any claim of [the account-party]."¹⁰⁹ Issuing banks might bolster such language by specifically referring to types of possible

¹⁰⁶ [1977] 3 W.L.R. 764 (C.A.).

¹⁰⁷ *Ibid.*, at p. 773; see, *supra*, text at footnote 48.

¹⁰⁸ (1979), 100 D.L.R. (3d) 546, 7 B.L.R. 102, 25 O.R. (2d) 167 (H.C.J.).

¹⁰⁹ *Ibid.*, at p. 548 D.L.R., p. 105 B.L.R.

disputes from which the banker's obligation would be insulated, including breach of contract, fundamental breach, insolvency or bankruptcy, cessation of business, misrepresentation and inadequacy in performance.

The language of a letter of credit, however, would not always be a reliable indicator of the parties' intention. Except for major financings, the letter of credit is not a negotiated document. Often it is a standard form imposed by the issuing bank or the beneficiary. The parties' intention should perhaps be determined primarily on the basis of underlying agreement and on the basis of the business function that the standby credit fulfils in the context.

The combined forces of high interest rates and recession, in recent years, have promoted the use of standby credits in situations where their use as the functional equivalent of cash is undeniable. In support of this, one need only consider their use in tax-shelter investments where the standby credit fees are low-cost alternatives to spread costs associated with actual advance payments. For example, a subscription for a film unit in a financing of a high-risk movie project might be purchased on the following terms:

The Film Units will be issued at a price of \$10,000 each. Subscribers for Film Units will be required to complete a Subscription Form . . . and submit the same to a selling agent, together with, for each Film Unit subscribed for:

- (i) a cheque in the amount of \$10,000 payable to the selling agent; or
- (ii) a cheque in the amount of at least \$1,000 payable to the selling agent, together with an interest-bearing Promissory Note in the form attached hereto as Schedule "C" for the balance of the Subscription Price, supported by a Letter of Credit issued by a Canadian chartered bank or other financial institution in the form of Schedule "C" hereto or in such other form as the Production Company's bankers may accept.

In the above example, the letter of credit is intended as an unconditional immediate credit facility. It is designed to enhance the credit of the beneficiary at the time of issuance as if cash had actually been paid. These were likely the circumstances surrounding the issuance of the letter of credit in *Henderson*.¹¹⁰ In such a case the letter of credit is given as a pure payment device and not as collateral security.¹¹¹ It resembles the commercial credit as much as a typical standby credit, but it is not employed

¹¹⁰ *Supra*, footnote 99.

¹¹¹ *Cf.*, *supra*, text at footnote 28.

in the conventional setting of the commercial credit and is classified as a standby credit. Functionally, it serves, immediately on its issuance, as the equivalent of a cash payment. It therefore functions as a payment mechanism earlier in time than the traditional commercial credit. It seems self-evident that such a letter of credit is intended to be autonomous, since it is intended to function as the equivalent of immediate cash payment.

The intention that the autonomy principle apply emerges clearly in connection with international project financing. Often, foreign governments insist on receiving a standby credit, drawable on simple demand, as a prerequisite to their dealing with a foreign investor. Corporations which procure the issuance of such letters of credit are aware of and accept the risks involved. Sound policy would not justify the interference by courts in such business decisions. *Edward Owen*,¹¹² the *Iraq case*¹¹³ and the *Iran case*¹¹⁴ all involved credits issued under such circumstances.

The position, however, is not so clear in all cases. In a domestic transaction, a standby credit could be used as collateral security rather than as an immediate cash equivalent. For example, where a landowner requires a construction company to provide a standby credit to secure performance of the construction contract, the parties may simply intend use of the credit as an inexpensive substitute for a performance bond.¹¹⁵ The standby credit is substantially cheaper, partly because of the advantages an issuing bank typically will have in obtaining security or relying on existing security. Normally, the construction company's assets are charged in favour of lenders such as the issuing bank. The surety on the performance bond will not be able to take security in the construction company's assets to protect its position on the latter's default.¹¹⁶ For that and other important reasons, the surety may charge substantially more than a bank for the facility offered by it. Accordingly, the parties' choice of the standby

¹¹² *Supra*, footnote 106.

¹¹³ *Supra*, footnote 93.

¹¹⁴ *Supra*, footnote 95.

¹¹⁵ The performance bond is a guarantee of performance. The obligee (landowner) may not call upon it in the absence of the principal's (construction company's) failure to perform. Stated otherwise, as against the obligee, the defence of the principal's performance is available to the surety.

¹¹⁶ Some aspects of the surety's security position vis-à-vis the construction lender, from an American law viewpoint, are discussed in B. Geva, "Bonded Construction Contracts: What are a Surety's Rights to Withhold Funds?", 3 Corp. L. Rev. 50 (1980).

credit may reflect an attempt to reduce costs, rather than a desire to have the autonomy principle apply.

In a situation such as that involved in *Aspen Planners*,¹¹⁷ where the landowner may be required by the construction company to procure the issuance of a letter of credit to ensure payment for the construction, the parties might intend the credit to serve as a guarantee of the landowner's payment obligations. Their choice of the standby credit might reflect the absence of any other credit facility tailored to their needs,¹¹⁸ rather than adoption of the autonomy principle.

Nevertheless, the application of the autonomy principle to the cases discussed in the two preceding paragraphs may be justified on the basis of the parties' intentions. Because they chose the standby facility, the parties were not forced to resort to a simple demand payment mechanism. Parties may have no control over the drafting of the letter of credit, but they do control the documentary requirements. Indeed, in a typical commercial credit setting, the banker is not required to pay on the seller's bare demand. Rather, a demand for payment on a commercial credit must be accompanied at least by the shipping documents evidencing actual shipment of the goods. Such documents are issued by the carrier, who is not a party to the seller-buyer contract. Not infrequently, under the terms of the credit, the seller's demand on the commercial credit must also be accompanied by a third party's certificate indicating the quality of the goods shipped. This requirement prevents the seller from making a discretionary demand.

In theory, control of documentary requirements is also available to users of the standby credit. Where the standby credit secures performance by a construction company, its terms should require that drawings by the landowner must be supported by an engineer's certificate specifying the construction company's failure of performance. Moreover, where the landowner's undertaking to pay a construction company is supported by a standby credit, as in *Aspen Planners*,¹¹⁹ the terms of the credit should provide for payment against a completion certificate issued by an

¹¹⁷ *Supra*, footnote 108.

¹¹⁸ Neither sureties nor financial institutions issue in the normal course of their businesses simple guarantees of monetary obligations.

¹¹⁹ *Supra*, footnote 108.

agreed engineer. In *Aspen Planners*, demands were to be made upon the production of the contractor's own certificate.¹²⁰

In other words, mechanisms protecting the account-party's rights can be established within the framework of the documentary requirements without undermining the autonomy principle. The parties' choice of the letter of credit device, accompanied by their own failure to build any protection mechanism into the documentary requirements, appears to justify the final result in *Aspen Planners*.

The preceding analysis presupposes that parties know what they are doing and that there is no defect in the bargaining process. At the same time, if parties are not aware of the autonomy principle and of the distinction between a standby credit and a performance bond or a guarantee, their failure to provide for proper documentary requirements cannot indicate their true intentions. One could attempt to meet this objection by arguing that two business parties, advised by lawyers, are presumed to know the law with regard to these matters. In reality, however, the possibility of the parties' ignorance of the implications of the use of letters of credit presents banks with a dilemma.

Courts may take seriously the question of the parties' ignorance of and even their lawyers' lack of insight in this technical area of banking law. The courts thus might attempt to encourage educational efforts to explain the crucial points to all concerned. When the courts determine that the parties' failure to provide for the appropriate documentary requirements reflects ignorance, rather than a deliberate intention in the context of the over-all contractual arrangement, they might be inclined to refuse to apply the autonomy principle. This might be accomplished by purporting to expand or liberally apply the exceptions to the principle, including the fraud exception. If this misfortune occurred, the autonomy principle would be fundamentally endangered, if not lost. There would also be no assurance that the doubts and uncertainties which would become associated with, and perhaps quickly destroy, the standby credit, would not also be carried to the traditional commercial credit. The fraud exception would be difficult to contain and might thus be broadened to include the making of a demand by a breaching

¹²⁰ See, *supra*, text which follows footnote 50.

seller. A buyer might be allowed to argue that in applying for the issuance of a letter of credit he was not aware of the autonomy principle and the related business risks. Undoubtedly the effectiveness of the letter of credit would be impaired.

Such developments would be regrettable. The letter of credit is used not only to provide the beneficiary with a solvent payor but also as a means of allocating to the applicant the interim financial burden during a contract dispute between the applicant and the beneficiary. Undermining the autonomy of the letter of credit would jeopardize its value as a payment device and also defeat the intentions of the parties. Furthermore, the virtually unconditional nature of the banker's undertaking underlies the utility of the letter of credit. The credit is immediate collateral in the hands of the beneficiary, who may wish to use the future proceeds of the credit as present security for loans from another bank.^{120a} The autonomy of the letter of credit is thus vital from a commercial standpoint. Its vitality must be ensured by careful drafting as well as by judicial caution.

In this framework, the few hard cases relating to standby credits can be viewed as aberrant. The cases are difficult to support. They involved situations in which the parties' intentions to employ the instruments as letters of credit, with all attendant consequences, were not easily discernible. To that extent, the cases should not cast serious doubt on the scope of the autonomy principle.

Conclusion

In *Aspen Planners*,¹²¹ Henry J. commented that "[n]either counsel has offered any submission why [the commercial credit], well established as an instrument of trade and commerce, should not be used in respect of building contracts."¹²² On this basis, he discussed the liability of the standby credit issuer within the framework of the law that had been established to apply to the liability of the commercial credit issuer.

There is no reported case setting out a reasoned response to the challenge posed by Henry J. It seems to be assumed universally

^{120a} For such a use of the letter of credit see *e.g.*, *Aspen Planners*, *supra*, footnote 108, at p. 552 D.L.R., p. 112 B.L.R.

¹²¹ *Supra*, footnote 108.

¹²² *Ibid.*, at p. 548 D.L.R., p. 106 B.L.R.

that the letter of credit is not only a payment mechanism in international trade but also a tool available for use as a standby credit facility, and that the applicant for a standby credit will successfully subject himself to the same body of law which governs use of the commercial credit in international sale of goods transactions. This premise is, however, to be treated with great caution.

As was indicated earlier,¹²³ as a matter of common law theory, there are doctrinal difficulties in finding a satisfactory basis for the binding effect of the issuer's engagement on any letter of credit. Mercantile usage has served as the most satisfactory solution to these difficulties, but this usage developed in connection with the older and well-established commercial credit. The standby credit is a recent phenomenon. Hence, the mercantile usage doctrine may not apply.

So far the question has been overlooked and perhaps it is only of marginal importance. After all, there are no doctrinal difficulties at common law in charging the issuer with a promissory estoppel from the time when the beneficiary has acted in reliance on the credit. The difficulty with the absence of consideration and the binding effect of the issuer's engagement relates only to the period between the beneficiary's receipt of advice of the credit and the time at which he acts upon it. Further, at least with respect to commercial credits, the difficulty is perhaps of little more than historical interest. Yet, the issue raises the broader question of the applicability of commercial credit mercantile usages and practices to the standby credit.

Even if governed by the same principles of law, standby credits involve factual settings different from those in which commercial credits are used. This gives rise to a potentially differing application of the governing principles in the two contexts. The failure to respond to this difference in context is reflected in the three Canadian injunction cases¹²⁴ and raises serious uncertainties as to the integrity of the letter of credit under Canadian law. The continued vitality of the standby letter of credit in Canada requires clear rejection of any tendency of Canadian courts to erode the autonomy principle. Even the more legitimate question of whether a particular instrument used in a given case is in fact a letter of credit — so that its autonomy and other attributes of the

¹²³ See, *supra*, text at footnotes 34-5.

¹²⁴ See, *supra*, text which follows footnote 95.

device would automatically apply — might best be resolved by legislation or more precise banking practice. Any attempt at judicial resolution, for example, by the development of objective intention rules, might leave the distinction less than categorical. In the time required for judicial development, uncertainty might do irreparable harm. In result, the standby credit, which originated as an expansion of the letter of credit, could jeopardize the utility of this well established and highly useful payment and financing device.

In the final analysis, the basis for autonomy depends on the parties' deliberate choice of the letter of credit facility. While the autonomy principle should be virtually absolute, subject only to the traditional narrow exceptions, the practical implications of autonomy should be attuned to the business objectives. This should be accomplished not by recognition of degrees of autonomy, but by specificity in related documentary requirements.

Where circumstances are such that the parties intend that the instrument be a letter of credit, courts may in hard cases refuse to apply the autonomy principle to what might in fact be a standby credit. To avoid unnecessary doubt and possible destruction of the standby credit, any difficulties in resolving characterization questions should be clearly addressed. In this way doubtful practices will be avoidable, the autonomy of the standby credit will be preserved and, most importantly, the commercial credit will not suffer any unintended ripple effect from the uncertainty surrounding standby credits.