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COMMENT

LETTERS OF CREDIT: CURRENT THEORIES AND USAGES

The letter of credit is no longer a financial tool available only to merchants dealing in international trade, nor is it a service which only the largest New York lending institutions can offer; rather the letter of credit is becoming an increasingly important element of our daily financial lives. Letters of credit issue from banks and other lending institutions in the largest metropolitan centers as well as the smaller rural communities. The use of this financial tool seems limited only by the creativity of man.

*Commercial Letters of Credit*¹

As the letter of credit first developed,² its use was limited

1. This section of this comment will deal primarily with the documentary credit and primarily with its use in sale-of-goods transactions. However, it should be noted that two other common forms of commercial credits are the "clean" credit and the "notation" credit. The "clean" credit is a letter of credit which obligates the issuer to pay merely upon presentment of a draft or demand to pay without requiring any other accompanying documentation. See *Fair Pavillions, Inc. v. First Nat'l City Bank*, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967); J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* 606 (1972). A "notation" credit is a letter of credit which states as one of its terms that any person who purchases or pays drafts drawn or demands for payment under the credit must make a notation of the amount of the draft or demand on the letter itself, usually in appropriate spaces and columns provided on the reverse of the letter of credit. U.C.C. § 5-108 (1972 version). See also 5 M. BENDER *U.C.C. SERVICES*, F. HART & W. WILLIER, *FORMS AND PROCEDURES* ¶ 51.02 (1977). U.C.C. § 5-108 was adopted verbatim in LA. R.S. 10:5-108 (Supp. 1974).

An interesting comparison between certain three-party credit card transactions, like VISA or MASTERCHARGE purchases can be drawn with the letter of credit, particularly a notation credit. In both instances the transaction involves three separate parties and three independent contracts or engagements. The function of the credit card or the letter of credit is to substitute the credit of a known solvent party, the bank, for the credit of the purchaser. Trade is facilitated in both instances. Both the notation credit and the credit card have certain established limits of credit which may not be exceeded; in both, the obligation of the credit-issuer and the card-issuer to pay the seller is independent of the contract between the issuer and its customer for reimbursement. Although the analogy falls short in certain areas, the similarities are striking and the analogy should provide a familiar concept to facilitate the reader's understanding. See B. CLARK & A. SQUILLANTE, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT*

to its primary or payment function.³ Since the turn of the nineteenth century, however, the letter of credit has served an increasingly important secondary or financing function.⁴ Broadly speaking, the payment function of a letter of credit is accomplished through the commercial letter of credit,⁵ which is also referred to as a documentary credit.⁶ The financing function of the letter of credit, from the customer's standpoint, is accomplished by the issuance of a letter of credit calling for an acceptance of the beneficiary's draft upon presentation of the required documents. From the beneficiary's standpoint, financing is accomplished through the use of transferable letters of credit and back-to-back letters of credit.⁷

A letter of credit is an unconditional promise to pay the draft or demand for payment of the beneficiary if the documents accompanying the draft comply with the terms of the

CARDS 191-92 (1970); Davenport, *Bank Credit Cards and the Uniform Commercial Code*, 85 BANKING L.J. 941, 948 (1968).

2. An in-depth historical study of the development of letters of credit is beyond the scope of this comment; however, excellent historical treatment can be found in B. KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS* (1966) and Comment, *Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions*, 4 CUM.-SAM. L. REV. 134 (1973).

3. Joseph, *Letters of Credit: The Developing Concepts and Financing Functions*, 94 BANKING L.J. 816-18 (1977).

Article 5 of the Uniform Commercial Code governs letters of credit. By 1974 La. Acts, No. 92, § 1, adding LA. R.S. 10:5-101-17, Louisiana adopted article 5 of the U.C.C. with very few changes.

4. See J. WHITE & R. SUMMERS, *supra* note 1, at 605; Comment, *supra* note 2, at 140.

5. Actually, the payment function is performed when the terms of the letter of credit are such that the draft or demand for payment is paid *on sight* when accompanied by complying documents. If the draft is a *time draft*, *i.e.*, payment is to be made within a specified number of days following receipt of the draft and complying documents, then as to the account party (see text at note 11, *infra*) the letter of credit performs a financing function, as he has a certain amount of time before he has to provide reimbursement to the issuer.

6. Joseph, *supra* note 3, at 816-17. Among the people in the trade a letter of credit is often referred to as a credit, while the term documentary credit is used to describe any letter of credit where payment will be made only when certain specified documents are presented with the demand for payment, and when payment will be made only if the documents conform to the precise terms of the letter of credit. *Id.* at 817-18. Thus the UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1974 Revision) by the International Chamber of Commerce refers to a "credit" or "documentary credit," while article 5 of the Uniform Commercial Code (1972 version) and LA. R.S. title 10, chapter 5, refer to documentary letters of credit as simply "credits."

7. See text at note 95, *infra*.

credit.⁸ Actually, compliance with a few formal requirements will establish a document as a letter of credit. The document must be in writing⁹ and signed by the issuer.¹⁰ A credit which is issued by a bank or another person and states conspicuously on the document that it is a "Letter of Credit" will be considered a letter of credit.¹¹ Furthermore, even if the document does not state that it is a letter of credit, if it is issued by a bank and requires a draft or demand for payment to be accompanied by specified documents, the document falls within the statutory definition of a letter of credit.¹² Similarly, if the credit is issued by a person other than a bank and requires the draft or demand for payment to be accompanied by documents of title, it too is legislatively deemed a letter of credit.¹³

The typical documentary credit in a sale-of-goods transaction involves basically three parties: the customer, known as the account party, who requests that a letter of credit be issued or "opened"; the issuer, typically a bank which at the customer's request opens a letter of credit; and the beneficiary, who is the person entitled to draft or demand payment under the credit.

The relationship among the various parties in a letter of credit transaction is illustrated by the following example. Suppose that a Louisiana merchant, B, decides that his spring line

8. The letter of credit concept has been defined in many ways. It has been defined as "a formal promise by a bank or another party of known solvency to accept and pay, or just to pay, the draft or the demand for payment by a beneficiary, whose compliance with the terms of the credit is a prerequisite of the enforceability of the promise." B. KOZOLCHUK, *supra* note 2, at 9.

9. U.C.C. § 5-104 (1972 version); LA. R.S. 10:5-104 (Supp. 1974). Hereafter only the citation to the Uniform Commercial Code will be given. The Louisiana Revised Statute which corresponds to the U.C.C. section will be found in title 10, under the same section number.

10. U.C.C. § 5-104 (1972 version).

11. U.C.C. § 5-102(1)(c) (1972 version).

12. U.C.C. § 5-102(1)(a) (1972 version). A national bank may issue any letter of credit permissible under article 5 of the Uniform Commercial Code or the Uniform Customs and Practice for Documentary Credits subject to certain additional restrictions imposed by the Comptroller of the Currency for safe and sound banking practice. 12 C.F.R. § 7.7016 (1978); see also text at note 134, *infra*.

13. U.C.C. § 5-102(1)(b) (1972 version). Actually there is no sound basis for the definition in 5-102(1)(b) that "documents of title" accompany a draft or demand for payment if a letter of credit is issued by one other than a bank. The language is understandable in the sale-of-goods transaction, but in other areas, such as standby letters of credit, there seems to be no reason for limiting the definition.

of goods should contain some sandals which are manufactured in Japan. B contacts the Japanese seller, S, proposing the purchase of a specified number of sandals. B says nothing about payment in his proposal. Since S knows nothing about B's solvency or ability to pay, S does not want to sell his sandals on open account, but instead suggests that B pay in advance. B is not willing to pay in advance for goods which he has not seen, so B suggests a letter of credit sale.¹⁴ S will stipulate that

14. It is immaterial whether the buyer or seller first suggests the use of a letter of credit. The situation postulated in the text is not the only instance in which a letter of credit might be introduced into a transaction. Frequently a buyer who could pay cash in advance will seek a letter of credit in order to draw upon the vast reservoir of knowledge and experience which a competent letter of credit department will possess. The members of the letter of credit department can confer with the account party, usually in person, in order to determine the myriad of issues and questions which could arise in a complex sale-of-goods transaction. Listed below are just a few of the many issues which will be resolved. Bear in mind that the issuer will not honor a presented draft or demand for payment unless the accompanying documents conform verbatim to the terms of the credit.

1) Will the account party accept only full shipments, or are partial shipments permitted?

2) What is the latest shipment date which will be accepted?

3) Is transshipment allowed? If transshipment *is not* allowed then the vessel upon which the goods are shipped from the point of origin *must* be the vessel which delivers the goods to the point of destination. Thus if transshipment is not allowed, a shipment of goods from port X in Spain to New Orleans, *must* arrive at New Orleans on the ship which originally left port X. In the foregoing example, if the point of destination is Alexandria, unless transshipment is allowed so that the goods could be shipped by truck, bus or rail from New Orleans to Alexandria, the issuer would have to dishonor the presented draft on the grounds of non-compliance with the terms of the credit because the goods did not arrive in Alexandria on the same vessel which left the point of origin.

4) Does the buyer wish to stipulate that the seller ship the goods by a particular ship or truck line? This is very important because some merchants receive a discount for shipments on particular lines. If the seller chooses a different line for shipment and the credit terms specify "F.O.B. point of shipment," *i.e.*, the buyer pays the freight charges from the point of shipment, the buyer's profit could be substantially reduced by the increased freight charges he must pay.

5) What is the nature of the goods to be shipped? This is also important because if the terms of the credit are "F.O.B. vessel" then the seller must, at his risk and expense, put the goods aboard the vessel. This is particularly important since a derrick barge would have to be rented at the dock to load the goods on the vessel if the goods could not be loaded by the ship's rigging.

6) Are the goods of such a nature that they cannot be placed in the ship's hold for shipment? Unless the credit allows an "on deck" shipment, the issuer will dishonor the draft for non-compliance if the accompanying documents indicate that the goods were transported on the deck of the vessel.

7) What type of insurance is sufficient? Is the effective coverage date of the

B cause the credit to be opened in his favor at a specified bank and further negotiations will complete the requirements of the credit. The bank will issue a credit naming S as beneficiary and listing certain documents which are to accompany his draft or demand for payment. S will ship the goods to the buyer and forward the documents to the issuer. Upon presentation of the documents and draft, if all is in order, the bank will pay S. The bank will then look to B for reimbursement pursuant to the security contract between B, as account party, and the bank.¹⁵

This illustration is greatly oversimplified because a host of details would have to be decided by the parties before the credit could issue. For example, a credit can be irrevocable or revocable.¹⁶ Under the U.C.C. an irrevocable credit cannot be revoked or modified without the consent of the parties to whom it has been established.¹⁷ A revocable credit can be modified or revoked unilaterally by the issuer, after establishment, without notice to or consent from either the customer or the beneficiary.¹⁸ A credit is established as to the customer when the letter

insurance co-extensive with the earliest point at which the risk of loss shifts to the buyer?

8) Does the buyer want to allow warehousing upon arrival?

The above are a few examples of the issues which would have to be anticipated and resolved prior to issuance of a credit. The expertise of bank letter of credit departments in anticipating and resolving issues of this sort is a strong basis in itself for the parties to consult with them when contemplating a letter of credit transaction.

15. Additional parties might include an "advising bank," which notifies the beneficiary that a credit has been issued in his favor, usually by another bank; or a "confirming bank," which by confirming the issuance of a credit in favor of the beneficiary places itself in the same relationship with the beneficiary in which it would have been had it opened the credit initially. U.C.C. § 5-107 (1972 version). See note 26, *infra*.

16. U.C.C. § 5-103(1)(a) (1972 version). U.C.C. § 5-106 defines the point at which the issuer may not unilaterally revoke or modify an irrevocable credit. U.C.C. § 5-106 (1972 version) states:

- 1) Unless otherwise agreed a credit is established
 - (a) as regards the customer as soon as a letter of credit is sent to him or the letter of credit or an authorized written advice of its issuance is sent to the beneficiary; and
 - (b) as regards the beneficiary when he receives a letter of credit or an authorized written advice of its issuance.
- 2) Unless otherwise agreed once an irrevocable credit is established as regards the customer it can be modified or revoked only with the consent of the customer and once it is established as regards the beneficiary it can be modified or revoked only with his consent

17. U.C.C. § 5-106(2) (1972 version).

18. U.C.C. § 5-106(3) (1972 version). Section 5-106(3) states: "(3) Unless other-

of credit is sent to him or an authorized, written advice of its issuance is sent to the beneficiary.¹⁹ A credit is established as to the beneficiary when he receives the letter of credit or an authorized, written advice of its issuance.²⁰

Furthermore, the letter of credit may be a straight or a negotiation credit. If it is a straight credit the named beneficiary is the only party entitled to payment and the beneficiary can negotiate the draft or demand for payment only with the issuing or "specially advised" party and not with an intermediary.²¹ If it is a negotiation credit the beneficiary may find a bank that will agree to negotiate his draft.²² For example, if the seller of the sandals in the earlier illustration received an irrevocable negotiation credit from the buyer in dollars, he could find the local Japanese bank which would allow him the highest rate of exchange and negotiate his draft.²³ If the credit had

wise agreed after a revocable credit is established it may be modified or revoked by the issuer without notice to or consent from the customer or beneficiary."

The U.C.C. will presume that all letters of credit are irrevocable unless the credit clearly states that it is revocable. U.C.C. § 5-103(1)(a). The Uniform Customs and Practice for Documentary Credits, however, contains the opposite presumption, *i.e.*, unless the credit clearly states that it is irrevocable, it is presumed revocable. INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS art. 1(c) (1974 revision).

19. U.C.C. § 5-106(1)(a) (1972 version).

20. U.C.C. § 5-106(1)(b) (1972 version). Note that the credit is established for the customer when sent by the issuer, whereas actual receipt by the beneficiary is required before it is established for him. Thus a recognized exception to the traditional mailbox rule of common law contracts could be available to prevent the establishment of an irrevocable credit in favor of the beneficiary. *See J. WHITE & R. SUMMERS, supra* note 1, at 618. Suppose that in the illustration given in the text at note 11, after B's bank sent by mail an irrevocable letter of credit to S, B requests the bank to cancel the credit or B is placed in bankruptcy and the bank desires to avoid what is likely to be an uncollectible debt. It appears from the language of the U.C.C. that the bank could send a telegram repudiating or revoking the "in transit" credit. Thus the credit is "overtaken" and never established for the beneficiary and U.C.C. § 5-106(2) is applicable. *See J. WHITE & R. SUMMERS, supra* note 1, at 618. There appear to be no cases squarely on point, probably because in actual practice the beneficiary is advised by cable or telegram that a credit has been issued in his favor long before the letter of credit arrives by mail.

21. B. KOZOLCHYK, *supra* note 2, at 27. *See also* Joseph, *supra* note 3, at 817-18 n.11.

22. B. KOZOLCHYK, *supra* note 2, at 27. *See also* Joseph, *supra* note 3, at 817-18 n.11.

23. B. KOZOLCHYK, *supra* note 2, at 27. Most negotiation credits issued by American banks expressly allow the negotiation of drafts under the credit by a clause such as the following: "We hereby agree with the drawers, endorsers and bona fide holders

been an irrevocable straight credit, the seller could have obtained payment only in Japanese currency at the bank mentioned in the credit.²⁴ The negotiation credit is probably the most useful form of credit in modern international trade as it allows the credit to be made out in a strong currency, so that the beneficiary can negotiate his draft at the best discount in relation to local currency.²⁵

of drafts drawn in compliance with the terms of this credit, that the same will be duly honored on presentation at the office of [issuer] on or before [expiration date]." *Id.* at 519-20.

The credit may contemplate the receipt from the beneficiary or negotiating bank of a time draft. A time draft is merely a written demand for payment which accompanies the documents required by the credit but is not payable upon presentment. Instead, a time draft "matures" at a certain time after the issuing bank accepts the draft and documents as complying with the terms of the credit. *See* U.C.C. § 3-410 (1972 version). In such a case, the clause may read as follows: "We hereby agree with the drawers, endorsers and bona fide holders that drafts drawn and negotiated in conformity with the terms of this credit will be duly accepted on presentation and duly honored at maturity." INTERNATIONAL CHAMBER OF COMMERCE, STANDARD FORMS FOR DOCUMENTARY CREDITS No. 7(A) (1974). Furthermore, a clause which is a composite of the above two clauses might be drafted so that either sight or time drafts would be honored under the terms of the credit. It must be noted that even in negotiation credits, the beneficiary is not thereby authorized to delegate his performance of the underlying transaction with the customer to another, he is authorized only to negotiate his draft in a manner consistent with the terms of the credit subject to the bank's determination of the documentary compliance with the terms of the credit. B. KOZOLCHYK, *supra* note 2, at 27. Probably the most common arrangement of negotiation credits is where the beneficiary is entitled to draw on either the issuing bank or its branch or correspondent bank at the beneficiary's domicile. *Id.*

24. Where a credit contemplates that *only* the named beneficiary is entitled to draw under the credit, and *only* in the currency of the beneficiary's domicile, the following clause might be inserted in the credit: "The above named opener of this credit engages *with you* that each draft drawn under and in compliance with the terms of this credit will be duly honored [on delivery of documents as specified at the office of paying bank on or before expiration date]." B. KOZOLCHYK, *supra* note 2, at 27 n.69. *See also id.* at 696 for an example of such a clause. The straight credit contemplated by the clause above is one which has been specially advised, *i.e.*, the advising bank has been requested by the issuing bank to be the paying bank also. *See* Joseph, *supra* note 3, at 817-18 n.11.

25. This type of negotiation credit is often called a circular negotiation credit. B. KOZOLCHYK, *supra* note 2, at 27-28.

Issuers of negotiation credits in the United States have an additional concern, the Foreign Asset Control Regulations of the federal government. The Foreign Asset Control Regulations delineate the foreign countries and currencies with which a United States citizen or business can deal and set forth elaborate reporting and disclosure procedures. These regulations are highly complex and a full discussion of this area is beyond the scope of this comment; however, the issuer and his legal adviser should thoroughly familiarize themselves with these regulations prior to the issuance of the credits. *See* Foreign Asset Control, 31 C.F.R. §§ 500-30 (1977).

The Letter of Credit and Traditional Contract Principles

The ordinary letter of credit transaction for the sale of goods involves three principal parties,²⁶ but there are only two

26. See text at note 13, *supra*.

Two possible additional parties to the letter of credit transaction are the advising bank and the confirming bank. An advising bank is a bank, usually in the beneficiary's locale or domicile and frequently a correspondent bank of the issuer, *i.e.*, a bank where the issuer has an account, which merely notifies the beneficiary that a letter of credit has been opened in his favor. A confirming bank serves precisely the same function, with one major distinction. The confirming bank, by confirming the issuance of a credit, becomes directly obligated to the same extent as the issuer to pay the presented draft or demand for payment when the accompanying documents comply with the terms of the credit. By such payment, the confirming bank would acquire the issuer's rights. U.C.C. § 5-107(2) (1972 version). Article 3 of the Uniform Customs and Practice for Documentary Credits (1974 Revision) is in accord. The advising bank does not assume any obligation of the issuer to honor drafts or demands for payment under the credit, but it does assume an obligation for the accuracy of the statement. U.C.C. § 5-107(1) (1972 version). In *National American Corp. v. Federal Republic of Nigeria*, 425 F. Supp. 1365 (S.D.N.Y. 1977), the court correctly held that an advising bank has no obligation beyond transmitting accurate information to the beneficiary. Article 3 of the Uniform Customs and Practice for Documentary Credits (1974 Revision) seems in accord.

The case of *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1224 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974), is illustrative of the problems which can arise if an advising bank accidentally confirms a credit. Bay Holding Co. was negotiating a loan from Barclays to develop real estate in the Carribean. Barclays refused to loan Bay Holding Co. the \$400,000 relying solely on the security furnished by Bay. Therefore, Bay contacted Allied, a non-bank mortgage broker, who issued an irrevocable letter of credit in Barclays' favor. Mercantile, at the insistence of its customer, Allied, wrote a letter "advising" Barclays that the letter of credit was opened in Barclays' favor. This letter and the letter of credit were rejected by Barclays as not conforming to current usage. Mercantile then sent a second letter along with Allied's letter of credit confirming that the credit was opened in Barclays' favor. Barclays later notified Allied that pursuant to the terms of the credit, it was presenting a 90-day draft. Barclays presented the promissory note to Bay Holding Co., which refused to pay it. Barclays then presented the draft to Allied, who dishonored, and to Mercantile, who dishonored.

As a defense to Barclays' wrongful dishonor suit, Mercantile claimed that the confirmation was in error because the responsible officer intended only to confirm the authenticity of Allied's signatures. The court rejected this claim and held that when a bank deals with another bank, it can assume that such bank is competent to conduct its own affairs, therefore Mercantile was presumed to know and understand the consequences resulting from its confirmation of Allied's credit.

Mercantile's second claim of defense was that dishonor was proper because the presented documents were non-conforming. The court noted the fact that the notice of dishonor sent to Barclays stated that Mercantile had received Barclays' draft "with all required Documentation called for in the Letter of Credit" and the bank therefore could not now allege non-compliance. 481 F.2d at 1237 n.10. See *Dovenmuehle, Inc. v. East Bank of Colorado Springs, N.A.*, 563 P.2d 24 (Colo. App. 1977).

traditional contracts and only one relationship which may be called either an obligation or an engagement. The customer will have a contract of sale with the beneficiary, which is sometimes referred to as the underlying transaction. The customer will have a contract of reimbursement with the issuer.²⁷ The relationship between the issuer and the beneficiary is not strictly contractual in nature, but it imposes an obligation to pay upon compliance with the terms of the credit.²⁸ The U.C.C. describes this obligation in the following manner: "An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract between the customer and the beneficiary."²⁹ Although the official comment seeks to classify the issuer-beneficiary relationship as "essentially contractual,"³⁰ such classification is questionable since the letter of credit does not resemble a contract in several respects, *e.g.*, it does not require consideration,³¹ a

Finally, Mercantile argued that no confirmation in fact existed since under U.C.C. § 5-103 a bank could not confirm a letter of credit issued by a non-bank and thus become directly liable to the beneficiary. Mercantile relied on U.C.C. § 5-103(1)(f) which states: "A 'confirming bank' is a bank which engages either that it will itself honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank." Mercantile claimed that the statute did not make sense unless "the issuer" was also a reference to a bank. The court refused to accept Mercantile's defense stating that the policy of the U.C.C. would not be furthered by such a ruling, nor was such a result contemplated by U.C.C. § 5-102(3) which states: "This Article deals with some but not all of the rules and concepts of letters of credit" 481 F.2d at 1231.

27. Banks which issue letters of credit wish to retain the greatest degree of flexibility in the transaction in order to protect their interest in the event of changed circumstances. Therefore, many issuers require the customer to sign a "security agreement" which is attached to or incorporated in the application form which the issuer requires its customer to fill out prior to issuance of a credit. This security agreement is usually quite extensive and is intended to place the issuer in a position of little or no risk of loss. Acceptance of the application is generally expressly stated to be acceptance of the security agreement. This writer feels that the accepted security agreement constitutes a binding contract of reimbursement once the credit is issued. It is a promise in return for performance supported by adequate consideration, and that is a contract. See note 28, *infra*.

28. J. WHITE & R. SUMMERS, *supra* note 1, at 607. See also Comment, *supra* note 2, at 142. For a discussion of the specific nature, liabilities and remedies among the various parties, see text at note 45, *infra*.

29. U.C.C. § 5-114(1) (1972 version).

30. U.C.C. § 5-114, comment (1) (1972 version).

31. U.C.C. § 5-105 (1972 version).

bargained for exchange of promises, or a meeting of the minds.³² Neither can a letter of credit properly be called a third party beneficiary contract, an assignment, or a guaranty for the following reasons.

The letter of credit is distinguishable from the third party beneficiary contract because of the types of defenses available to the issuer (promisor). In a third party beneficiary contract, the rights of the third party beneficiary depend on the validity of the contract between the promisor and the promisee. The promisor can assert any defense against the third party beneficiary that the promisor could assert against the promisee,³³ including defects in the contract between the promisor and promisee which developed after the formation of the contract, such as intervening fraud or subsequent illegality.³⁴ However, in the letter of credit transaction, once an irrevocable letter of credit is established for the beneficiary, the issuer must honor the draft or demand for payment by the beneficiary if the documents accompanying the credit conform with its terms. This is true even if the customer has repudiated the contract, become insolvent, defrauded the issuer, or refused to perform according to the terms of his contract with the issuer.³⁵

32. A contract is a legally enforceable agreement between two or more persons which consists of a bargained for exchange of promises or a promise in exchange for actual performance by another supported by executed consideration. L. SIMPSON, HANDBOOK OF THE LAW OF CONTRACTS 1-7 (2d ed. 1965). However, U.C.C. § 5-105 expressly states that the letter of credit need not be supported by any consideration. Moreover, the issuer-beneficiary relationship cannot be properly termed an agreement, because generally the issuer and beneficiary are wholly unknown to each other prior to the issuance of the credit. J. WHITE & R. SUMMERS, *supra* note 1, at 607. Although the terms of the credit may reflect the mutual assent of the customer and the beneficiary to those terms, the issuer does not engage in the negotiations between the customer and the beneficiary, so there cannot be an agreement or meeting of the minds between the issuer and the beneficiary. See L. SIMPSON, *supra*, at 3, 7. Since a bargained for exchange of promises is absent, the relationship can not be a bilateral contract. The letter of credit is not a unilateral contract either, *i.e.*, a promise by one party in return for actual performance by another party. *Id.* at 5-6. The unilateral contract is not binding on the parties until performance, yet the mere designation of a letter of credit as irrevocable, coupled with receipt by the beneficiary, completes the issuer's obligation to pay pursuant to the terms of the credit. See text at note 16, *supra*.

33. RESTATEMENT (SECOND) OF CONTRACTS § 140 (1973). For example, if A owes a debt to C, he may enter into a contract with B that, in exchange for consideration from A, B promises to discharge A's debt to C. In such a case, lack of mutual consent, prescription, fraud or duress would all be assertable by B in a suit brought by C.

34. *Id.*

35. J. WHITE & R. SUMMERS, *supra* note 1, at 607.

Similarly, the beneficiary in a letter of credit arrangement is not an assignee of a contract right formerly held by the customer. The customer, according to the terms of a letter of credit, does not have the right to draw drafts under the credit; only the beneficiary is so entitled.³⁶ Also, in a true assignment, the obligor can assert any defenses against the assignee which he could have asserted against the assignor.³⁷ The beneficiary of a letter of credit is immune from defenses that the issuer has against the customer as long as the beneficiary has complied with the terms of the credit.³⁸

Neither can the issuer's obligation be properly classified as one of suretyship or guaranty, for either of two sound reasons. First, in contracts of suretyship or guaranty, the surety is liable only if the beneficiary is unable to collect from the principal obligor, *i.e.*, the surety is a secondary obligor.³⁹ However, the issuer in a letter of credit transaction is a primary obligor and is liable to the beneficiary upon compliance with the terms of the credit, notwithstanding any discrepancies in the underlying contract between the customer and the issuer or between the customer and the beneficiary.⁴⁰ Secondly, the surety can assert nonpersonal defenses of the obligor against the obligee. In a letter of credit transaction, however, the issuer cannot defeat the beneficiary's demand for payment by asserting a defense which the customer had against the beneficiary.⁴¹

36. *Id.* at 607-08.

37. L. SIMPSON, *supra* note 32, at 278-82.

38. See, *e.g.*, U.C.C. §§ 5-09, 5-114 (1972 version); Arnold and Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C.L.J. 272, 274-75 (1977).

39. J. WHITE & R. SUMMERS, *supra* note 1, at 608. The textual statement is only true if the surety does not sign the original document of indebtedness. If the surety signs the instrument, he is an accommodation party and is primarily liable on the instrument. U.C.C. § 3-415 (1972 version). In Louisiana the contract of suretyship is accessory to the principal obligation, LA. CIV. CODE art. 3035, and the surety is likewise secondarily liable, *i.e.*, his liability is predicated on the debtor's failure to pay. *Id.* However, if the surety is liable in solido with the debtor, he is a primarily liable party as to the creditor. This resembles a letter of credit relationship with the beneficiary, except that the issuer of a letter of credit cannot assert any defenses against the beneficiary which the customer would have against the beneficiary. A solidary surety, on the other hand, may assert any non-personal defenses of the debtor. LA. CIV. CODE arts. 3060, 2098.

40. U.C.C. § 5-114 (1972 version); J. WHITE & R. SUMMERS, *supra* note 1, at 608.

41. U.C.C. § 5-114 (1972 version); J. WHITE & R. SUMMERS, *supra* note 1, at 607. A letter of credit is not a negotiable instrument, although the draft drawn under it may

While the letter of credit transaction cannot properly be called contractual, courts nevertheless apply traditional rules of contract interpretation to the terms of letters of credit: thus, if the issuer repudiates the credit after establishment but prior to presentment, the issuer will be deemed to have "anticipatorily breached a contract" for which damages are due;⁴² letters of credit will be interpreted in a manner that tends to uphold rather than defeat the credit;⁴³ and the terms of letters of credit will be "construed as strongly against the issuer as a reasonable reading will justify."⁴⁴

*Interrelated Liability Among the Parties*⁴⁵

The interrelated liability among the parties, particularly

be negotiable, because the credit generally does not meet the requirements for negotiability of U.C.C. § 3-104(1), particularly the requirement of an unconditional promise or order to pay to bearer or to order. U.C.C. § 3-104(1)(b), (c) (1972 version). See J. WHITE & R. SUMMERS, *supra* note 1, at 608. However, it appears possible to draft a negotiable letter of credit under the flexible guidelines of article 5 of the Uniform Commercial Code. Henry Harfield presented an example of a use of letters of credit which illustrates this point at the Fifth Annual Uniform Commercial Code Institute in New York City. He hypothesized that ABC, Co. might desire to raise money by selling its obligations in the commercial paper market, but could not assure the marketability of the issued promissory notes unless its credit were supported by that of another solvent institution. A bank might therefore agree to issue the same number of letters of credit as the promissory notes issued by the ABC, Co., and in the amount of the face value of each note. For convenience one letter of credit could be printed on the reverse side of each promissory note. If the beneficiary of the credit were the bearer of the promissory note and the credit was a "clean" credit, *i.e.*, only a demand for payment was necessary to entitle the beneficiary to payment, the letter of credit arguably would be a negotiable instrument. Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C.L.J. 251, 253 (1972). For the problems which the foregoing example raises if the issuing bank is a national bank, see text at note 134, *infra*.

42. *J. Zeevi & Sons v. Grindlay's Bank (Uganda)*, 37 N.Y. 220, 333 N.E.2d 168, 371 N.Y.S.2d 892 (1975), *cert. denied*, 423 U.S. 866 (1976).

43. *Dynamics Corp. v. Citizens & S. Nat'l Bank*, 356 F. Supp. 991 (N.D. Ga. 1973).

44. *West Va. Housing Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1109 (W.D. Pa. 1976); *Chase Manhattan v. Equibank*, 394 F. Supp. 352, 354 (W.D. Pa. 1975), *vacated on other grounds*, 550 F.2d 882 (3d Cir. 1977).

45. As discussed in the text at note 13, *supra*, in a letter of credit transaction in the sale-of-goods context there are principally three parties, issuer, beneficiary and customer; two contracts, customer-beneficiary and customer-issuer; and one obligation, issuer-beneficiary. See text at note 26, *supra*. The concerns of the issuing bank focus on the two contracts; two questions are central, namely:

a) When can the issuing bank dishonor the beneficiary's presented draft in order to protect its interests?

between the issuer and the beneficiary, arises at the point the credit becomes "established." Once an irrevocable credit becomes established, the credit can only be modified or revoked with the consent of the parties involved.⁴⁶ The U.C.C. operates

b) What can the issuing bank do to insure that the customer will reimburse the bank for funds paid in connection with the letter of credit?

46. See text at note 16, *supra*. See also U.C.C. § 5-106, comment (1) (1972 version) which states: "The primary purpose of determining the time of establishment of an irrevocable credit is to determine the point at which the issuer is no longer free to take unilateral action with respect to the cancellation of the credit or modification of its terms."

One recent case addressed the question of whether the issuer's assent is needed to modify the terms of the credit, or whether the concurrent assent of both the beneficiary and the customer is sufficient to accomplish a modification of the credit. In *AMF Head Sports Wear, Inc. v. Ray Scott's All-American Sports Club, Inc.*, 448 F. Supp. 222 (D. Ariz. 1978), Ray Scott's caused an irrevocable letter of credit to open in favor of AMF for the purchase of sporting goods. The credit stipulated that delivery was to be made to Scottsdale, Arizona. However, AMF shipped the goods to Columbus, Indiana, pursuant to an agreement with Ray Scott's. The bank refused to pay the presented draft for non-compliance, and AMF sued for wrongful dishonor. The sole issue was whether the issuer was under a duty to modify the credit terms at the request of both the customer and the beneficiary. The plaintiff introduced depositions of the issuer's officers which indicated that the issuer had issued the credit without checking Ray Scott's financial status; that at the time the draft and accompanying documents were presented the issuer had reason to believe that Ray Scott's would be unable to reimburse the issuer; that through dishonor of the draft for non-compliance the issuer was able to extricate itself from this precarious financial situation; and that the issuer thereafter refused to amend the credit. The plaintiff alleged that the general obligation of good faith under article 5 of the U.C.C. required the issuer to amend the credit. 448 F. Supp. at 224. The court rejected this contention, citing U.C.C. § 1-201(19), *i.e.*, that good faith means honesty in fact in the transaction, and stating that this issuer had not been dishonest. Plaintiff's second allegation was that general banking usages required the issuer to amend the credit. 448 F. Supp. at 224. The issuer, however, proved to the satisfaction of the court that the trade usage which governed was article 3(c) of the UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, which requires the assent of all parties to amend the credit. *Id.* Although it was not held that the U.C.P. codified all banking custom, the court was satisfied that in Arizona no contrary custom or usage exists. *Id.*

The court was quite correct in holding that the assent of *all* parties is required to modify the credit for two reasons. First, U.C.C. § 5-102(3) states that article 5 deals with some, but not all rules and concepts which govern a letter of credit transaction. Therefore, although U.C.C. § 5-109(1) states specifically that the issuer's obligation to the customer includes the observance of general banking usage, section 5-109 would not prohibit the application of general banking usage to the beneficiary also. See U.C.C. § 1-205 (1972 version). Thus even if the credit does not expressly state that the provisions of the U.C.P. are applicable to the beneficiary and customer, the U.C.P. should be applied as a general banking usage to require the assent of all parties. This is particularly so since the provisions of the U.C.P. generally govern the actual practices of the banking industry regarding letters of credit. Interview with Boris Kozol-

to keep an established irrevocable credit valid, unless the parties consent to a change, even where the customer fraudulently induces the issuance of the credit, or a mutual mistake is made regarding the terms of the credit, or the customer repudiates his contract with the beneficiary prior to compliance with the terms of the credit.⁴⁷ Section 5-106 states that after an irrevocable credit is established as regards the customer, but prior to establishment regarding the beneficiary, the issuer may revoke or modify the credit only with the customer's consent.⁴⁸ However, if the letter of credit is sent to the customer to forward to the beneficiary and the issuer thereafter discovers fraud, duress or mistake, the issuer should be allowed to revoke the credit without the customer's consent if he can obtain actual possession of the letter of credit before it is established as to the beneficiary.⁴⁹ Also, if the credit is still in the possession of the customer, an injunction should be obtainable to prevent the customer from forwarding the credit to the beneficiary.⁵⁰

After an irrevocable credit has been established as to *both* the customer and the beneficiary, the issuer must honor any draft or demand for payment complying with the terms of the credit.⁵¹ The issuer who refuses to honor the draft or demand

chyk, Professor of Law, author of *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS* (1966), in Baton Rouge, Louisiana (Feb. 14, 1979).

Secondly, there appears to be no commercially reasonable or desirable reason for requiring the issuer to assent to a request for modification of the credit by the customer and beneficiary. Indeed, such a result would be likely to inhibit the use of letters of credit because the issuer would become subject to numerous possibly undesirable amendments, e.g., an amendment to increase the credit amount, to make a non-transferable credit transferable, etc. Such a rule would have the effect of negating one of the general goals of the Uniform Commercial Code, to permit the continued "expansion of commercial transactions." U.C.C. § 1-102, comment (1) (1972 version).

47. U.C.C. § 5-114(1) (1972 version). See J. WHITE & R. SUMMERS, *supra* note 1, at 617-18. In at least one case, the court held that a beneficiary could not have assented to a modification of the terms of the credit due to the ambiguous language used by the issuer in seeking the modification. *Asociacion de Azucareros de Guatamala v. United States Nat'l Bank of Oregon*, 423 F.2d 638 (9th Cir. 1970). For a discussion of this case, see note 77, *infra*, and accompanying text.

48. U.C.C. § 5-106(2) (1972 version). For the text of § 5-106, see notes 16, 18, *supra*.

49. J. WHITE & R. SUMMERS, *supra* note 1, at 618.

50. *Id.* Since an injunction is an equitable remedy, an injunction should be obtainable against the customer or the beneficiary if the issuer can meet the requisite proof of irreparable harm. See LA. CODE CIV. P. arts. 3601-13.

51. U.C.C. § 5-114(1) (1972 version).

for payment may be liable for wrongful dishonor.⁵² Wrongful dishonor arises under the U.C.C. when the issuing bank is presented with complying documents and refuses to honor the accompanying drafts,⁵³ or when the bank delays honor of the presented, complying documents and drafts beyond the close of the third banking day following receipt and the presenter does not expressly or impliedly consent to an extension of time.⁵⁴

The issuer's wrongful dishonor, according to section 5-115 of the U.C.C., allows the beneficiary the remedies accorded a seller under the Uniform Commercial Code.⁵⁵ Section 2-710 is the principal provision of the Code which addresses the damages awardable to the seller for the buyer's breach of contract; it includes in addition to contractual damages such incidental damages as "commercially reasonable charges, expenses or commissions."⁵⁶

Section 5-115's incorporation of the U.C.C. seller's remedies presents a problem in Louisiana, since the state has not adopted the sales provision of the U.C.C.⁵⁷ The apparent hiatus

52. Two exceptions to this general principle will be discussed in the text at note 66, *infra*.

53. U.C.C. §§ 5-114(1), 5-115(1) (1972 version).

54. U.C.C. § 5-112 (1972 version). This article provides as follows:

- (1) A bank to which a documentary draft or demand for payment is presented under a credit may without dishonor of the draft, demand or credit
 - (a) defer honor until the close of the third banking day following receipt of the documents; and
 - (b) further defer honor if the presenter has expressly or impliedly consented thereto.

Failure to honor within the time here specified constitutes dishonor of the draft or demand and of the credit.

This article waives the usual time period for a bank to dishonor an instrument under article 4 of the U.C.C., *i.e.*, generally a bank must send notice of dishonor by midnight of the day of receipt, U.C.C. § 4-301, whereas § 5-112 allows the bank three days following receipt. The reason for the longer time is simple; since the bank must examine the draft or demand for payment and the accompanying documents and determine whether the terms of the credit have been met, it must be given sufficient time to do so.

55. LA. R.S. 10:5-115(1) (Supp. 1974) states that the person entitled to honor, generally the beneficiary, has the rights of a seller against an issuer for wrongful dishonor. The Louisiana statute deleted the reference to U.C.C. § 2-710 which is found in U.C.C. § 5-115(1) since article 2 has not been adopted in Louisiana.

56. U.C.C. § 2-710 (1972 version).

57. By 1974 La. Acts, No. 92, Louisiana adopted articles 1, 3, 4 and 5 of the Uniform Commercial Code and codified them as title 10 of the Revised Statutes. By

is filled by reference to Revised Statutes 10:1-103, which states that provisions of Louisiana law which are not displaced by the adopted U.C.C. sections remain in force. The beneficiary's remedies in the event of wrongful dishonor, therefore, are determined by resort to Louisiana law on sellers' remedies.⁵⁸ Application of the Louisiana sales law principles to the wrongful dishonor situation gives rise to two questions:

- (1) Does wrongful dishonor constitute passive breach of contract under Civil Code article 1931, thus necessitating a "putting in default" before suit? and
- (2) What are the damages assessable in such a breach?⁵⁹

Since an active breach of contract is defined as doing something inconsistent with the obligation of the contract,⁶⁰ the issuing bank's refusal to pay the draft or demand should be considered an active breach.⁶¹ However, a wrongful dishonor arising from the issuing bank's delay under section 5-112 more

1978 La. Acts, Nos. 164 and 165, Louisiana adopted Uniform Commercial Code articles 7 and 8, respectively. However, Louisiana has failed to enact Uniform Commercial Code articles 2, 6, 9, and 10. See LA. R.S. 10:1-101, comment (Supp. 1974).

58. This result is mandated by two reasons, (a) Louisiana did not adopt article 2, and (b) when Louisiana adopted LA. R.S. 10:1-103 (Supp. 1974) the legislature rejected the original U.C.C. text which read as follows: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions." The legislature then supplanted the rejected text with the following: "Unless displaced by the particular provisions of this Title, the other laws of Louisiana shall apply." LA. R.S. 10:1-103 (Supp. 1974).

59. Planiol and Ripert have stated that damages due to the non-performance of an obligation are of two kinds:

- (a) natural and ordinary damages which were foreseeable by the debtor and which he is bound to pay in every case; and
- (b) exceptional damages which were unforeseeable by the debtor and he is not bound to pay these unless the debtor has perpetrated fraud on the creditor.

2 PLANIOL ET RIPERT, *TREATISE ON THE CIVIL LAW* § 250 (11th ed. 1939). This entire area of letter of credit law needs an in-depth treatment on the extent to which the provisions of LA. R.S. 10:5-101-5-117 (Supp. 1974) are supplemented by other provisions of Louisiana law, but such a treatment is beyond the scope of this article.

60. LA. CIV. CODE art. 1931. Conceptually it is difficult to speak of any breach of "contract" between the issuer and beneficiary when there is no traditional contract relationship, but merely an obligation or engagement owed to the beneficiary by the issuer. See text at note 27, *supra*.

61. For an active breach of contract no putting in default is necessary. LA. CIV. CODE art. 1932. See also *Allen v. Steers*, 39 La. Ann. 586, 2 So. 199 (1887); *Levy v. M. Schwartz & Bros.*, 34 La. Ann. 209 (1882).

closely resembles a passive breach. A passive breach of contract is defined as "not doing what was covenanted to be done, or not doing it at the time, or in the manner stipulated or implied from the nature of the contract."⁶² With a passive breach of contract the creditor, in most transactions, cannot maintain an action against the debtor until the debtor is "put in default."⁶³ Moreover, damages in a passive breach are due only from the time that the debtor has been "put in default."⁶⁴ In an active breach, however, damages are due from the moment of the "act of contravention."⁶⁵

There are two exceptions to the rule that the refusal of the issuing bank to honor drafts or demands for payments will be a wrongful dishonor. The first exception occurs when the documents presented for payment do not conform to the terms of the letter of credit, and the second when the implication of section 5-114(2) applies.⁶⁶ Each will be discussed separately.

Perhaps the issue most frequently presented in letter of credit cases in which the issuer has refused to pay is whether the presented documents complied with the terms of the credit.⁶⁷ This problem is foreseeable given the nature of most letters of credit transactions, *i. e.*, the transactions often involve numerous parties and translations of the credit and the accompanying documents into various foreign languages. Nonetheless the issuer is unconditionally bound to honor the drafts of the beneficiary or other presenter if the documents conform to the terms of the credit under penalty of liability for wrongful dishonor. The U.C.C. is silent as to whether substantial compliance with the terms of the credit will be sufficient to invoke

62. LA. CIV. CODE art. 1931.

63. LA. CIV. CODE art. 1933. See *Temple v. Lindsay*, 182 La. 22, 161 So. 8 (1935); *Jennings-Heywood Oil Syndicate v. Houssiere-Latreille Oil Co.*, 119 La. 793, 44 So. 481 (1907).

64. LA. CIV. CODE art. 1933.

65. LA. CIV. CODE art. 1932. Although there are no Louisiana cases discussing the nature of the issuer's breach in letter of credit transactions, application of the code principles seems clear. If the bank delays honor beyond the time allowed in § 5-112, the bank's actions constitute a passive breach of contract and a "putting in default" is necessary. LA. CIV. CODE art. 1933. If the bank refuses to pay the draft or demand for payment then the refusal constitutes an active breach of contract.

66. See text at note 80, *infra.*

67. J. WHITE & R. SUMMERS, *supra* note 1, at 621.

the issuer's obligation to pay,⁶⁸ although there seems to be nothing in the U.C.C. which prohibits the customer and issuer from contracting that substantial compliance with the credit terms will suffice.⁶⁹

In the absence of an agreement between the customer and the issuer permitting payment upon substantial compliance with the terms of the credit, it is important to examine the documents accompanying the draft or demand for payment for strict compliance. An example of the strict compliance standard can be found in *Bossier Bank & Trust Co. v. Union Plant-*

68. In the case of *Marine Midland Grace Trust Co. of New York v. Banco Del Pais, S.A.*, 261 F. Supp. 884 (S.D. N.Y. 1966), the issuing bank, Marine, refused to pay drafts drawn under an irrevocable letter of credit since the terms of the credit stated that the draft should be accompanied by a "full set clean on board trucker's bill of lading." The documents presented did not state that the goods were "on board," and the bank refused payment for non-compliance with the terms of the credit. The defendant, Banco, answered that the bill of lading was in the customary Mexican form, which does not specify "on board" for truckers' bills of lading. The court stated that nothing less than strict compliance with the terms of the credit would bind the issuer to pay. *Accord Anglo-South American Trust Co. v. Uhe*, 261 N.Y. 567, 184 N.E. 741 (1933); *North Woods Paper Mills Ltd. v. National City Bank of New York*, 283 App. Div. 2d 731, 127 N.Y.S.2d 663 (1954).

In *Far Eastern Textile, Ltd. v. City Nat'l Bank & Trust Co.*, 430 F. Supp. 193 (S.D. Ohio 1977), the defendant, City National, opened an irrevocable letter of credit in favor of Far Eastern. The credit provided that the inspection certificate covering the goods was to be signed by "Larry Fannim." The presented certificate of inspection was signed "Larry Fannim by Paul Thomas." City National refused to honor the draft on the ground of non-compliance; Far Eastern sued for wrongful dishonor. The court properly noted that the issuing bank performs a mere ministerial function and should not be concerned with the underlying contract between the customer and the beneficiary; thus, unless the agency arises from the terms of the credit itself, the bank need not look beyond the presented documents to determine whether such agency in fact exists. The court approved a bifurcated standard of compliance, *e.g.*, when the suit is against the issuer by the beneficiary for wrongful dishonor, the applicable standard of compliance is nothing less than strict; however, when the suit is by the customer against the bank for wrongful honor the standard is merely substantial compliance. *Id.* at 196, *citing Marine*.

69. Article 5 deals primarily with the letter of credit itself and not with the underlying issuer-customer and customer-beneficiary contracts. However, one of the basic tenets of all the U.C.C. articles is clearly the freedom of contract between the parties. This freedom of contract is subject to the good faith of the contracting parties and the exercise of ordinary care. U.C.C. §§ 1-203, 5-109 (1972 version). The freedom of contract principle can be evidenced by the provisions of article 5 which would allow the parties to vary the statutory result by their contract. U.C.C. §§ 5-106(1), 5-106(2), 5-106(3), 5-107(1), 5-107(4), 5-109(1), 5-109(2), 5-110(1), 5-110(2), 5-111(1), 5-111(2), 5-113(2)(a), 5-113(2)(b), 5-114(2), 5-114(3).

ers National Bank of Memphis.⁷⁰ The plaintiff, Bossier Bank, loaned \$450,000 to Shreve Square, Inc. after Shreve Square, Inc. had caused Union Planters to open an irrevocable letter of credit in favor of Bossier Bank. The terms of the credit were that Bossier Bank submit its demand for payment along with a written statement "to the effect that you are entitled to draw under this Letter of Credit in reduction of the loan to Shreve Square on the River, Inc. pursuant to the terms of your commitment letter dated January 21, 1973."⁷¹ The commitment letter of Bossier Bank apparently stated the conditions upon which Bossier Bank would call the credit. Bossier Bank subsequently sent its draft and the written statement to Union Planters. The issuer, Union Planters, refused to honor the draft claiming that Bossier Bank fraudulently "called" the letter of credit for a purpose not contemplated by the parties to the underlying contract. Bossier Bank sued for wrongful dishonor. The court, ruling in Bossier Bank's favor, refused to consider whether the condition which prompted Bossier Bank to call the credit was in fact one contemplated by the parties to the underlying contract. The court held that the underlying contract is distinct and separate from the issuer's obligation to pay upon proper presentment of complying documents. By a strict interpretation of the terms of the credit, all that was required to invoke the issuer's obligation to pay, was a *statement* that the presenter was entitled to payment under the credit regardless of whether Bossier Bank was in fact entitled to payment.⁷²

In *Courtaulds North America, Inc. v. North Carolina National Bank*,⁷³ the issuing bank had to decide whether to pay the presented draft when the complying documents did not strictly comply with the terms of the credit. The account party, desiring to purchase yarn from the plaintiff, Courtaulds, caused the defendant bank to open an irrevocable letter of credit in Courtaulds' favor. The terms of the credit stated, *inter alia*, that the draft was to be accompanied by "Commercial

70. 550 F.2d 1077 (6th Cir. 1977).

71. *Id.* at 1079.

72. *Id.* at 1081-82 (emphasis added). The court also applied the familiar principle of contract interpretation that any ambiguity in a contract or document is construed against the maker. *Id.* at 1082. See LA. CIV. CODE art. 1957.

73. 528 F.2d 802 (4th Cir. 1975).

invoice in triplicate stating . . . 100% Acrylic Yarn"⁷⁴ Several shipments were received from Courtaulds in which the presented documents did not strictly conform to the terms of the credit. In each instance, the defendant bank gave notice of the discrepancies to the account party, who then waived the right to object to the deficiencies; thereafter the bank honored the drafts. The shipment at issue arrived with a draft and an invoice which stated "Imported Acrylic Yarn,"⁷⁵ which by industry custom was in fact 100% acrylic yarn. The bank called the account party to obtain a waiver of any objection to the discrepancy; however, when the account party told the bank that he had gone into bankruptcy and only the bankruptcy trustee could make such a decision, the bank immediately dishonored the draft for non-compliance; Courtaulds sued for wrongful dishonor. The court rejected Courtaulds' contention that the prior dealings of the parties either had amended the terms of the credit or had constituted a waiver of the right to object to the discrepancies in the shipment at issue and held that the beneficiary must strictly comply with the terms of the letter of credit in order to obligate the issuer to pay. *Courtaulds* illustrates that since issuers deal in paper, they are justified in dishonoring a draft when the accompanying documents do not strictly comply with the credit, even though the goods to which the documents refer do in fact comply with the credit terms.⁷⁶

74. *Id.* at 804.

75. *Id.*

76. There are numerous cases in which the courts have upheld the issuer's refusal to pay when there was a discrepancy between the terms of the letter of credit and the presented documents. The following is a partial list of these cases with the conflicting provisions of the credit and presented documents in parentheses: *Filley v. Pope*, 115 U.S. 213 (1885) (shipment from Leith v. shipment from Glasgow); *Banco Espanol de Credite v. State Street Bank and Trust Co.*, 385 F.2d 280 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968) (goods to be as sample inspected in Spain v. sample as per order-stock sheet); *Crocker First Nat'l Bank of San Francisco v. DeSousa*, 27 F.2d 462 (9th Cir. 1928) (150 tons . . . refined granulated sugar and 350 tons . . . refined fine granulated sugar v. granulated sugar (150 tons) and fine sugar (350 tons)); *Mitsubishi Goshi Kaisha v. J. Aron & Co., Inc.*, 16 F.2d 185 (2d Cir. 1926) (Dallas to East Rochester v. f.o.b. . . . Pacific Coast); *Banco Nat'l Ultramarino v. First Nat'l Bank of Boston*, 289 F. 169 (D. Mass. 1923) (white crystal sugar v. Brazil white crystal sugar); *International Banking Corp. v. Irving Nat'l Bank*, 283 F.103 (2d Cir. 1922) (striped Fuji silk . . . as per your sample 400 v. made as per our designs and total width of stripes not more than 50% of the material width); *Brown v. Ambler*, 66 Md. 391, 7 A. 903 (1881) (yellow pine lumber v. yellow pine flooring); *laudise v. American Exchange Nat'l Bank*, 239 N.Y. 234, 146 N.E. 347 (1924) (Alicante Bouchez Grapes v. Grapes);

A contrary result was reached by the courts in *Asociacion de Azucareros de Guatemala v. United States National Bank of Oregon*.⁷⁷ In this case the court held the issuing bank liable for wrongful dishonor when the bank failed to inquire into the practices of the sugar industry in order to determine whether the presented documents complied with the terms of the credit. The case should not be followed⁷⁸ as it violates one of the most

Bank of Italy v. Merchants Nat'l Bank, 236 N.Y. 106, 140 N.E. 211 (1923) (raisins v. dried grapes); Lamborn v. Lakeshore Banking and Trust Co., 231 N.Y. 616, 132 N.E. 911 (1921) (java white sugar v. java white granulated sugar); Oriental Pacific (U.S.A.), Inc., v. Toronto Dominion Bank, 78 Misc. 2d 819, 357 N.Y.S.2d 957 (Sup. Ct. 1974) (ladies sweaters, dresses, pants and skirts as per purchase order no. 848 v. woolen knitwears); Talbot v. Bank of Hendersonville, 495 S.W.2d 548 (Tenn. App. 1972) (The invoice bore the verbatim language required by the credit, but only as a notation, and the itemized invoice listed non-complying parts; held, the bank was not required to honor the draft where the notation but not the invoice conformed to the strict terms of the credit); National City Bank v. Seattle Nat'l Bank, 121 Wash. 476, 209 P. 705 (1922) (granulated white sugar, Java No. 24 v. standard white granulated sugar); Bank Melli Iran v. Barclay's Bank, [1951] 2 T.L.R. 1057 (K.B.) (goods' new v. 100, new good); J. H. Rayner & Co. v. Hambro's Bank, Ltd., [1943] 1 K.B. 37 (C.A.) (machineshelled groundnut kernels v. Coromodel groundnuts).

77. 423 F.2d 638 (9th Cir. 1970). The account party wanted to purchase sugar from the plaintiff, *Asociacion*. Thereafter the account party caused the defendant bank to open an irrevocable letter of credit in favor of the plaintiff. The terms of the credit were that the bank would pay 90% of the invoice value after presentment of documents stating, *inter alia*, "5,000 Long Tons . . . Bulk Raw Centrifugal Sugar of the 1965/66 Crop, F.O.B. . . . basis 96 degrees minimum polarization." *Id.* at 639. The word "polarization" is a term of art in the sugar trade, definitional in character, as the degree of polarization denotes the purity of the sugar. Raw sugar thus has a polarization range of 94-98 degrees. Upon arrival of the shipment the sugar polarized at 95.176358 degrees instead of 96 degrees as per the terms of the credit. The customer then requested the bank to contact *Asociacion* and seek a modification of the credit to 75% of the invoice value due to the lower polarization of the sugar. The bank did so and *Asociacion* consented to the modification. When it contacted *Asociacion*, the bank said that the sugar was "below credit requirements," *id.* at 641, and *Asociacion* took this to mean that the sugar was below 94 degrees. When *Asociacion* learned of the true deficiency, it sued for the difference between the 75% of the invoice value paid and the original 90% claiming that the false statement by the bank entitled *Asociacion* to rescind the modification and reinstate the original terms. The district court ruled in favor of the plaintiff and the appellate court affirmed, holding that by definition "raw sugar" must be between 94 and 98 degrees, therefore the word "minimum" in the credit was superfluous. Thus the court erroneously held that the bank should have made inquiries concerning the trade definitions with which it was dealing and failed to understand that the credit's use of "96 degrees minimum" was intended to assure that the sugar met a minimum level of purity.

78. Another case which has reached an incorrect result is *Venizelos, S.A. v. Chase Manhattan Bank*, 425 F.2d 461 (2d Cir. 1970). Essentially, this factually complex case concerned an agreement where customers of the defendant bank wished to

basic letter of credit principles, *i.e.*, that the issuing bank is not required to look beyond the terms of the credit and the presented documents in order to decide whether to honor the draft.⁷⁹

The second instance in which an issuing bank can dishonor drafts or demands for payment drawn under the credit is when the implication of section 5-114(2) is applicable.⁸⁰ The impact

import certain goods from the plaintiff, Venizelos. To this end an irrevocable letter of credit was opened in the plaintiff's favor by Banco Azteca and then confirmed by the defendant bank. The terms of the credit specified 1) the transport ship, 2) that the imported goods be about 9,690 metric tons, and 3) that no partial shipments were to be allowed, *i.e.*, all 9,690 metric tons were to be shipped at the same time. A later amendment to the credit increased the number of tons importable to 19,300 metric tons, but provided that all other terms of the original credit would remain unchanged. When Venizelos presented his draft based on a shipment of 9,300 metric tons, the bank refused to honor the draft as it represented a partial shipment. The plaintiff sued for wrongful dishonor. The court held that since the credit stipulated the transport ship, the bank had or should have had knowledge of the carrying capacity of the ship, approximately 10,000 metric tons, and therefore the bank had incorrectly interpreted the amended letter of credit as prohibiting partial shipments, a construction which defeated the amended credit. Like *Asociacion*, this case imposed liability on the issuing bank for not looking beyond the terms of the documents in deciding whether to pay.

Venizelos and *Asociacion* remain the minority view among courts which have addressed the issue; the majority do not impose liability on the issuer for failing to look beyond the terms of the credit and the presented documents in determining whether to honor the draft or demand for payment. *Chase Manhattan Bank v. Equibank*, 550 F.2d 882 (3d Cir. 1977); *Decker Steel Co. v. Exchange Nat'l Bank of Chicago*, 330 F.2d 82 (7th Cir. 1964); *Dulien Steel Products, Inc. v. Bankers Trust Co.*, 298 F.2d 836 (2d Cir. 1962); *Cooper's Finer Foods, Inc. v. Pan American World Airways, Inc.*, 178 So. 2d 62 (Fla. App. 3d Cir. 1965); *Tueta v. Rodrigues*, 176 So. 2d 550 (Fla. App. 2d Cir. 1965).

79. Note, *An Issuing Bank's Duty of Payment Under an Irrevocable Letter of Credit: Association [sic] de Azucareros de Guatemala v. United States National Bank of Oregon*, 12 ARIZ. L. REV. 835 (1970).

80. See text at note 66, *supra*. U.C.C. § 5-114(2) (1972 version). LA. R.S. 10:5-114(2) (Supp. 1974) states:

Unless otherwise agreed when the documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title or of security or is forged or fraudulent or there is fraud in the transaction,

(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course and in an appropriate case would make it a person to whom a document of title has been duly negotiated or a bona fide purchaser of a security; and

(b) in all other cases as against its customer, an issuer acting in good

of 5-114(2) is that the issuer may refuse to honor the drafts of the beneficiary, but is not required to do so,⁸¹ if:

- a) the documents required by the credit do not conform to the warranties made on negotiation or transfer of a document of title or of a security,⁸² or
- b) the document is forged or fraudulent,⁸³ or
- c) there is "fraud in the transaction."

However, if the party presenting the draft or demand for payment is a holder in due course⁸⁴ or a person to whom a document of title has been negotiated or a bona fide purchaser of a security, the issuer may not refuse to honor the presented draft.

Although 5-114(2) lists three instances when an issuer may dishonor a draft with impunity even if the documents strictly comply with the terms of the credit, the U.C.C. fails to define certain essential terms in 5-114(2)—forged or fraudulent documents. White and Summers define forged documents under 5-114(2) as those with forged signatures,⁸⁵ but a fortiori the section should apply equally if the document itself is forged. White and Summers also define a "fraudulent" document within the terms of 5-114(2) as "one that is specious, conjured up out of whole cloth, or one that has been materially altered."⁸⁶ Although the case law on this issue is quite scarce, one recent case defines fraud for 5-114(2) purposes in a rational and logical manner. In *West Virginia Housing Development Fund v. Sroka*,⁸⁷ the district court in dictum stated that where fraud is alleged between the original parties and the customer tells

faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the document but a court of appropriate jurisdiction may enjoin such honor.

LA. R.S. 10:5-114(2) (Supp. 1974) differs mainly from the official U.C.C. text of § 5-114(2) only with respect to references to other articles of the U.C.C. which were not adopted in Louisiana. See note 57, *supra*.

81. U.C.C. § 5-114(2)(b) (1972 version).

82. U.C.C. § 5-114 (2) (1972 version).

83. It is important to note that § 5-114(2) addresses itself only to forged or fraudulent documents and not forged or fraudulent drafts. J. WHITE & R. SUMMERS, *supra* note 1, at 624 n.104.

84. U.C.C. § 5-114(2)(a) (1972 version). See U.C.C. § 3-302 (1972 version).

85. J. WHITE & R. SUMMERS, *supra* note 1, at 624-25.

86. *Id.* at 625.

87. 415 F. Supp. 1107 (W.D. Penn. 1976).

the bank not to pay, 5-114(2)(b) is applicable.⁸⁸ According to the court, unless the bank has notice of the fraud, forgery or defect it cannot avoid liability for wrongful dishonor if the terms of the credit are met; however, if the bank has such notice, it has the option under 5-114(2)(b) to decide whether to honor the draft. Noting that the Uniform Commercial Code does not define fraud, the court stated that letter of credit cases should invoke the traditional concept and definition of fraud, *i.e.*, an "intentional misrepresentation in order to profit from another."⁸⁹ In *Sroka*, the court applied a narrow definition of fraud in interpreting section 5-114(2)(b) because the beneficiary had not been guilty of unscrupulous conduct. However, by stating that the issuing bank's independent obligation to pay should "not be extended to protect an unscrupulous beneficiary,"⁹⁰ the court indicated a willingness to broaden the definition of fraud with respect to unscrupulous beneficiaries. In support it cited the principal case of *Szetejn v. J. Henry Schroder Banking Corp.*⁹¹

Szetejn is considered the leading pre-U.C.C. case illustrating the "fraud in the transaction" phrase of 5-114(2).⁹² *Szetejn* involved the most egregious fraud imaginable. In that case the documents included the required indication that fifty cases of

88. In *Sroka*, the plaintiff, West Virginia Housing Development Fund (Fund), loaned \$3,317,500 to Bridgeport Gardens Associates (B.G.A.) so that B.G.A. could build low-cost housing. *Sroka* was the general partner of B.G.A. For insurance reasons, the Department of Housing and Urban Development (HUD) agreed to endorse B.G.A.'s mortgage note if B.G.A. would cause an irrevocable letter of credit to open in Fund's favor, which B.G.A. did. B.G.A. defaulted on the loan and HUD paid the loan amount less the amount of credit. The issuer refused to pay Fund's draft upon presentment. The issuer's defense to Fund's suit was that Fund was in bad faith in presenting the draft because Fund knew that the funds represented by the credit were no longer available to the plaintiff after B.G.A.'s default on the loan; therefore the issuer was not bound under section 5-114(2)(b) to pay the draft. The court rejected this argument.

89. 415 F. Supp. at 1114.

90. *Id.* It is the author's opinion that the *Sroka* court was quite correct in refusing to read the fraud requirement in 5-114(2) broadly, as the utility of the letter of credit in commercial transactions is due in large part to the certainty of payment which it gives to the beneficiary. If fraud in 5-114(2) is read broadly, some certainty would be lost. Customers who wished to breach their obligations in the transaction would try to prevent the issuer from paying a presented draft or demand for payment, accompanied by complying documents, by alleging facts which otherwise might be relatively unimportant.

91. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

92. J. WHITE & R. SUMMERS, *supra* note 1, at 625.

brush bristles had been shipped, although the "goods" shipped were actually fifty cases of rubbish. The court enjoined payment at the request of the customer. If this case establishes the standard for "fraud in the transaction," then the option to refuse payment under section 5-114(2) is not available if the underlying transactions are infected with ordinary fraud, such as a knowing misrepresentation as to the quality of the goods, or a breach of warranty by the beneficiary.⁹³ Furthermore, the protection afforded by the fraud provision is limited in another respect—if the presenter falls within one of the three protected classes of 5-114(2)(a), even egregious fraud, such as in *Szetejn*, would not permit dishonor.⁹⁴

Back-to-Back Letters of Credit

The previous sections of this comment have dealt with the payment function of commercial or documentary letters of credit in a sale-of-goods transaction in which the beneficiary was the provider of the goods or the manufacturer-seller.⁹⁵ Letters of credit also perform an important financing function when the beneficiary-seller is not the ultimate producer of the goods but is a middleman. This can be accomplished by use of the back-to-back credit.

In order to understand the back-to-back letter of credit transaction, consider the following illustration. Suppose that the Louisiana merchant causes an irrevocable documentary credit to be opened in favor of the Japanese seller of sandals. If the seller is a middleman, he will need to procure the requisite amount of sandals from the sandal manufacturer in order to comply with the terms of the credit issued in his favor. It may be that he does not have the capital readily available to pay the manufacturer in advance, or the credit to borrow the capital needed, and the manufacturer is unwilling to sell on open account. The middleman therefore will cause a second letter of credit to open in favor of the manufacturer. Some of the terms of the second credit will differ from the terms of the

93. *Id.* See also *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*, 356 F. Supp. 991 (N.D. Ga. 1973).

94. U.C.C. § 5-114(2)(a) (1972 version).

95. See the illustration in the text at note 13, *supra*.

first credit. For example, the amount of the second credit will be less because the middleman will buy the sandals from the manufacturer at a price below what he is charging the Louisiana merchant in order to make a profit and the date for delivery of the sandals under the second credit will be earlier than that required under the first credit so that the middleman can comply with the first credit's terms. However, the description of the goods in the second credit must conform to the terms of the first credit if the middleman expects to be paid. The manufacturer will ship the sandals to the point of destination stipulated in the second credit and the required documents and a draft or demand for payment to the issuer of the second credit. If the documents comply with the credit, the manufacturer will be paid by the issuer of the second credit, who will send the documents on to the middleman as agreed. The middleman will then ship the sandals to the issuer of the original credit along with the requisite documents under the credit. The initial issuer will then honor the draft drawn by the middleman, who in turn will reimburse the issuer of the second documentary credit.⁹⁶ The Louisiana buyer will then reimburse the initial issuer and take possession of the sandals.

This process can of course encompass several successive middlemen and can be quite complex. Because of the integrating function of intermediate issuers, refusal to pay by any such issuer because of non-compliance with the terms of a back-to-back credit can disrupt the entire transaction. Another commonly encountered problem is the unwillingness of an issuer of a subsequent credit to rely on the contract for reimbursement from the customer after the successful completion of the transaction. This may cause the issuer to require some security before opening a credit in favor of the manufacturer. Since most letters of credit state that the draft or demand for payment will not be paid unless accompanied by conforming documents *and* the original letter of credit, the second credit issuer might require the middleman to pledge the first letter of credit before it will open the second credit in favor of the manufacturer. Since the second issuer would then retain possession of the first credit, the middleman would not be able to forge complying

96. See J. WHITE & R. SUMMERS, *supra* note 1, at 605.

drafts and documents and present them for payment to the issuer of the first credit. This retention of the original credit has been called negative security.⁹⁷

*Decker Steel Co. v. Exchange National Bank of Chicago*⁹⁸ was a case involving back-to-back credits. Decker entered a contract to buy steel from Associated through First National Bank. Associated was a middleman, and in order to procure the needed steel, Associated assigned its rights to the proceeds⁹⁹ from the initial letter of credit to Exchange National as security for the opening of an irrevocable letter of credit in favor of the steel supplier, Brown. When the time for Associated to deliver the steel passed without delivery, Decker notified Associated that due to the delay (and the price of steel falling 25%) Decker could no longer accept delivery of the steel. Associated did not notify Exchange National. Brown timely presented a draft and complying documents to Exchange and Exchange honored the draft. Exchange presented the draft and complying documents to First National and was paid. The steel was shipped to Decker who sold it at a loss and sued Exchange for wrongful presentment. The court held that banks in letter of credit transactions deal in documents only and that in determining whether or not to pay the presented draft they need not look beyond the documents to the underlying transaction disputes. Therefore, Decker's suit against Exchange was dismissed.¹⁰⁰

Although back-to-back credits can perform a valuable financing function, at least one noted authority states that because of the potential problems which are involved, banks may refuse to issue back-to-back credits for customers for whom an independent credit would not be issued.¹⁰¹

97. B. KOZOLCHYK, *supra* note 2, at 490.

98. 330 F.2d 82 (7th Cir. 1964).

99. Even if the credit is designated as non-transferable or non-assignable, under U.C.C. section 5-116(2) the beneficiary may assign his right to the proceeds under the credit before performance of the conditions of the credit. Under LA. R.S. 10:5-116(2) (Supp. 1974) such an assignment is treated as an assignment of a credit right under the Civil Code and is governed by articles 2642 *et seq.* Article 47 of the Uniform Customs and Practice for Documentary Credits allows a beneficiary to assign his right to the proceeds under the credit even if it is designated as non-transferable in "accordance with the provisions of the applicable law." INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 6, art. 47.

100. 330 F.2d at 84.

101. B. KOZOLCHYK, *supra* note 2, at 490.

Transferable Credits

A second financing function of letters of credit can be achieved by the use of a transferable credit.¹⁰² The transferable credit transaction must not be confused with the back-to-back credit situation. In the transferable credit transaction the letter of credit is made available to a new beneficiary.¹⁰³

The following example of a transferable credit transaction illustrates the distinctions between transferable credits and back-to-back credits.¹⁰⁴ Our Louisiana merchant causes his bank to open an irrevocable, transferable letter of credit in favor of the seller of goods, who happens to be a middleman. In order to assure the manufacturer of the goods that the order will not be withdrawn, or to prevent the middleman from having to obtain pre-payment for the goods, the middleman, as beneficiary of the letter of credit, will *transfer* to the manufacturer his rights under the credit, *i.e.*, his right to supply the goods and receive payment upon presentment of a draft or demand for payment accompanied by complying documents.

The main problem surrounding transferable credits is a general confusion regarding the respective liabilities of the parties.¹⁰⁵ Does the transferor remain personally liable to the issuer if the transferee fails to perform?¹⁰⁶ Does a transfer of the letter of credit render the transferee liable only for performance within the terms of the credit, or for performances of the underlying contract with the account party also?¹⁰⁷ The U.C.C. is silent as to the proper resolution of these issues.

102. Under U.C.C. § 5-116(1) the right to draw under a letter of credit can only be assigned or transferred if the credit expressly states that it is transferable. Under the Uniform Customs and Practice for Documentary Credits, the right to draw under a letter of credit can only be transferred pursuant to article 46; it can be only assigned once, and only if the credit expressly states that it is *transferable*. Other terms, such as "assignable," are wholly unacceptable. INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 6, art. 46.

103. B. KOZOLCHYK, *supra* note 2, at 491.

104. See text at note 95, *supra*.

105. B. KOZOLCHYK, *supra* note 2, at 491-502.

106. U.C.C. § 5-116, comment 2 (1972 version) states:

"[If a letter of credit is transferable under 5-116(1)], the normal rules of assignment apply and both the right to draw and the performance of the beneficiary can be transferred, subject to the beneficiary's continuing liability, *if any*, for the nature of the performance." (Emphasis added).

107. B. KOZOLCHYK, *supra* note 2, at 502.

The issuers of transferable credits may also be concerned about the potential for beneficiary double-dealing in transferable credits, *i. e.*, when the beneficiary transfers the right to draw under the credit to the transferee while retaining a copy of the credit and then either negotiates it or presents it along with a draft and forged documents for payment.¹⁰⁸ To prevent such an abuse, the credit can provide that no draft will be honored unless accompanied by the original letter of credit. If the transferor were to attempt such double-dealing with a credit containing such a clause, any subsequent holder of a draft not accompanied by the original credit would be put on notice and thus deprived of holder in due course status.¹⁰⁹

A transferee could be protected against transferor double-dealing by requiring the transferor-beneficiary to sign a notice of assignment or transfer which reasonably identified the letter of credit transaction and contained a request by the transferor-beneficiary that the issuer pay the transferee. The notice of assignment or transfer would then be sent to the issuer and the transferee would take possession of the letter of credit (original). If such a procedure were followed, an issuer who paid another by mistake would remain liable to the transferee.¹¹⁰

Standby Letters of Credit

Although the letter of credit developed primarily as a documentary credit in the sale-of-goods transaction,¹¹¹ since the early nineteenth century the use of the secondary or financing function has increased greatly due to the use of transferable credits and back-to-back credits.¹¹² However, the use of another important type of letter of credit has also increased—the standby letter of credit.¹¹³ A standby letter of credit obligates

108. J. WHITE & R. SUMMERS, *supra* note 1, at 635.

109. U.C.C. § 5-114(2)(a) (1972 version). See note 80, *supra*, and accompanying text.

110. J. WHITE & R. SUMMERS, *supra* note 1, at 637. See also U.C.C. § 5-116(2) (1972 version).

111. See text at note 4, *supra*.

112. See text at note 95, *supra*.

113. This section will treat the standby letters of credit as being governed by the provisions of the Uniform Commercial Code and thus issuable by one other than a bank. U.C.C. § 5-102 (1972 version). Additional problems are presented when such a credit is issued by a bank, particularly a national bank. See text at note 134, *infra*.

the issuer to honor the draft or demand for payment by the beneficiary upon a failure of performance of the underlying transaction.¹¹⁴ While in the documentary or commercial letter of credit, the issuer's obligation to pay is independent, separate, and distinct from the underlying transaction, in the standby letter of credit transaction the issuer's obligation to pay is intimately related to the underlying transaction.¹¹⁵ This distinction prevents the standby credit from being called a documentary credit, even though the credit will almost always state that the draft or demand for payment must be accompanied by a document stating that one of the parties to the underlying transaction, other than the beneficiary, has failed to perform and the presenter is thus entitled to draw under the credit.¹¹⁶

The standby credit is the most recent development in the field of letter of credit law and its use is increasing daily in contexts formerly considered inappropriate for use of a letter of credit.¹¹⁷ Standby letters of credit have been used to guarantee payment of salaries,¹¹⁸ as collateral security for loans,¹¹⁹ as

114. See Harfield, *The Increasing Domestic Use of Letters of Credit*, 4 U.C.C. L.J. 251, 258 (1972); Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697, 699 (1975).

Although the Uniform Commercial Code does not explicitly address the standby letter of credit, the standby credit easily fits within the ambit of the omnibus clause of section 5-102 which states: "[This chapter applies] (c) to a credit issued by a bank or other person if the credit is not within subparagraphs (a) or (b) but conspicuously states that it is a letter of credit or is conspicuously so entitled." U.C.C. § 5-102(1)(c) (1972 version). Similarly, U.C.C. § 5-103(1)(a) is also broad enough to include the standby credit. It provides:

(a) "Credit" or "letter of credit" means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Chapter (5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.

115. Katskee, *supra* note 114, at 701.

116. See, e.g. *Prudential Ins. Co. of America v. Marguette Nat'l Bank of Minneapolis*, 419 F. Supp. 734 (D. Minn. 1976); *American Empire Ins. Co. v. Hanover Nat'l Bank of Wilkes-Barre*, 409 F. Supp. 459 (M.D. Penn. 1976), *aff'd mem.*, 556 F.2d 564 (3d Cir. 1977).

117. For an excellent discussion of cases which illustrate the many uses to which letters of credit are currently being put, see Joseph, *supra* note 3. See also Harfield, *supra* note 51.

118. In *Beathard v. Chicago Football Club, Inc.*, 419 F. Supp. 1133 (N.D. Ill. 1976), the football players had insisted that the defendant World Football League franchise holder secure a letter of credit in their favor to guarantee payment of their

a substitute for performance and libel bonds,¹²⁰ as security for

salaries. The W.F.L. franchise defaulted and the players sought payment under the credit. The court held that the players were not entitled to payment under the credit because the credit was revocable and was revoked prior to presentment of the drafts and notice of defendant's default.

119. In *West Virginia Housing Development Fund v. Sroka*, 415 F. Supp. 1107 (W.D. Penn. 1976), the plaintiff, Fund, executed a \$3,317,500 loan to the partnership, Bridgeport Garden Associates, of which Sroka was a general partner, in order for Bridgeport to build low-cost housing. HUD agreed to endorse Bridgeport's mortgage note to Fund provided that as a condition to the contract between HUD and Fund, Fund would require Bridgeport to provide an irrevocable letter of credit in favor of Fund to minimize HUD's liability should Bridgeport default. Bridgeport defaulted on a balance of \$764,868.24, and HUD paid Fund the amount of the balance less the amount of the standby credit. Fund was entitled to recover the amount of the credit from the issuer, also a party defendant. *Accord* *Lindy v. Lynn*, 395 F. Supp. 769 (E.D. Penn. 1974), *aff'd mem.*, 515 F.2d 507 (3d Cir. 1975).

In *Harvey Estes Const. Co. v. Dry Dock Savings Bank of New York*, 381 F. Supp. 271 (W.D. Okla. 1974), Dry Dock agreed to provide permanent financing for Estes' construction project. Estes was to pay a loan commitment fee of \$85,000 to Dry Dock, half was paid in cash, half was put in escrow secured by an irrevocable standby credit in Dry Dock's favor which would be payable if the loan did not close, refundable to Estes if it did. The loan failed to close and Dry Dock was held entitled to payment under the credit.

In *Brummer v. Bankers Trust of South Carolina*, 268 S.C. 21, 231 S.E.2d 298 (1977) the plaintiff was the bankruptcy trustee for Phillips Development Corp. Phillips entered into a loan with Manhattan Life Co. for \$1,750,000 and as a condition thereto Phillips was to pay a loan commitment fee of \$35,000, half of which was secured by Bankers' irrevocable letter of credit. Phillips went into bankruptcy and Brummer, the plaintiff, sought to enjoin Bankers from honoring Manhattan's draft. Manhattan was allowed recovery, although the court mistakenly held that the credit was not a standby letter of credit.

120. In *American Empire Ins. Co. v. Hanover Nat'l Bank of Wilkes-Barre*, 409 F. Supp. 459 (M.D. Penn. 1976), *aff'd mem.*, 556 F.2d 564 (3d Cir. 1977), American issued performance bonds for a contractor after the contractor caused Hanover to issue an irrevocable credit in favor of American. The terms of the credit allowed American the right to draw under the credit if it incurred any obligation due to its role as surety for the account party. When the contractor defaulted, American was allowed to recover under the credit.

In *National Sur. Corp. v. Midland Bank*, 551 F.2d 21 (3d Cir. 1977) National Surety refused to issue a release of a libel bond on a ship held by United States marshalls as to unrelated litigation without collateral from Astrorico Compania Noviera, S.A., the ship's owner. Astrorico caused Midland to issue an irrevocable standby letter of credit in favor of National Surety which authorized the beneficiary to draw an aggregate of \$10,250 under the credit if Astrorico failed to pay the judgment and National Surety thereby suffered liability. Astrorico failed to pay the judgment and the court held Midland's refusal to honor was unjustified and allowed National Surety to recover. *See also* *Victory Carriers, Inc. v. United States* 467 F.2d 1334 (Ct. Cl. 1972); *Techem Chem. Co., Ltd. v. MIT Choya Maru*, 416 F. Supp. 960 (D. Md. 1976).

permanent financing¹²¹ and for interim financing,¹²² and to perform other functions limited only by the ingenuity of the prac-

121. In *Chase Manhattan Bank v. Equibank*, 550 F.2d 882 (3d Cir. 1977), Chase agreed to extend permanent financing of the construction costs of building a motel to the builder upon completion of the project. The builder was to furnish an irrevocable letter of credit in Chase's favor, payable upon presentment of a sight draft and certification that the builder had defaulted on its obligation under the underlying transaction. The credit guaranteed that Chase would receive its fee in the event of default. Equibank issued the credit in favor of Chase. Chase's commitment to extend permanent financing was contingent upon completion of the project by April 30, 1973, at which time the credit also expired by its terms. The loan closing was set for April 27, 1973, but the builder failed to appear. Chase immediately sent a telex message to Equibank requesting payment and on April 30 Chase telephoned Equibank during business hours to confirm the telex message and to confirm that the draft and proper documents would be sent via regular channels. When Equibank received the draft and confirmation of default on May 10, it dishonored for untimely compliance. Chase sued for wrongful dishonor alleging that the April 30 telephone conversation was a waiver by Equibank of the time limitation of the credit. The district court granted summary judgment for Equibank without reaching the waiver issue, holding that the issuer could not modify the terms of the credit without the applicant's consent.

The court of appeals reversed and remanded holding that if a waiver in fact occurred, the customer's consent to a unilateral modification of the credit by the issuer would be unnecessary since the issuer-beneficiary and issuer-customer relationships are independent. The court stated:

If the issuing bank, by choice or inadvertence, waives a restriction in the letter of credit and pays the beneficiary despite the noncompliance, the issuer jeopardizes its right to reimbursement from the customer. The possibility that the issuer may not be able to recover from the customer, however, does not bar the beneficiary in his suit against the bank. The beneficiary bases his claim on the letter of credit as modified by the bank and acceptable to him—not on the agreement between the customer and the issuing bank, nor upon the underlying arrangement between customer and beneficiary.

550 F.2d at 886.

Chase provides a good example of the problem which may face a court when the applicable portions of the U.C.C. and the U.C.P. conflict. In *Chase* the court construed U.C.C. § 5-106(2), which provides that after establishment with respect to the customer, the irrevocable credit can only be modified or revoked with his consent, yet the customer's consent is not needed to effect a modification with respect to the beneficiary. Thus the issuer must pay the draft under the modified credit while faced with the possibility of not being reimbursed by the customer—because he did not consent to the modification. A different result would have occurred by application of the U.C.P. The court noted that the provisions of the U.C.P. were applicable as were those of the U.C.C., yet under article 3(c) of the U.C.P., the consent of all parties is required to effect a cancellation or amendment of the credit after establishment. The court in *AMF Head Sports Wear, Inc. v. Ray Scott's All-American Sports Club, Inc.*, 448 F. Supp. 222 (D. Ariz. 1978), held that the issuer's consent, as well as the beneficiary's and customer's consent, was necessary to amend an irrevocable credit. See note 46, *supra*. Thus under the U.C.P. Equibank would have succeeded in its defense that no modification occurred; and therefore Chase would not have been entitled to payment because of non-compliance.

122. *Meltzer v. Crescent Leaseholds, Ltd.*, 315 F. Supp. 142 (S.D.N.Y. 1970), *aff'd per curiam*, 442 F.2d 293 (2d Cir. 1971).

itioner.¹²³

The issuance of a standby letter of credit is an assumption of a greater risk than that incurred in issuing a documentary credit in a sale-of-goods transaction. This is true because in the standby credit transaction, the beneficiary can draw under the credit only if the underlying transaction has failed.¹²⁴ If the beneficiary becomes entitled to draw under the credit due to the account party's default on the underlying obligation, the bank's claim for reimbursement from the account party may well be worthless.¹²⁵ Furthermore, when the underlying transaction involves an obligation by the account party, the issuing bank will not even have the protection which it is afforded in the sale-of-goods transaction.¹²⁶

123. *Trans World Airlines, Inc. v. Hughes*, 515 F.2d 173 (2d Cir. 1975), cert. denied, 424 U.S. 934 (1976) (\$75 million credit used in lieu of a suspensive appeal bond); *Wichita Eagle & Beacon Publishing Co., Inc. v. Pacific Nat'l Bank of San Francisco*, 493 F.2d 1285 (9th Cir. 1974) (credit in favor of lessor to guarantee lessee's performance held to be a guaranty contract because the issuer was required to look beyond the documents in determining whether to pay); *Transport Management Co. v. American Radiator & Standard Sanitary Corp.*, 326 F.2d 62 (3d Cir. 1963) (credit used as proof of financial responsibility); *Dulien Steel Products, Inc. v. Bankers Trust Co.*, 189 F. Supp. 922 (S.D. N.Y. 1960), *aff'd*, 298 F.2d 836 (2d Cir. 1962) (payment of brokers' fees); *Prudential Ins. Co. v. Marquette Nat'l Bank of Minneapolis*, 419 F. Supp. 734 (D. Minn. 1976) (payment of loan commitment fees); *Fair Pavillions, Inc. v. First Nat'l City Bank*, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967) (credit used to secure construction progress payments); *Brummer v. Bankers Trust of South Carolina*, 268 S.C. 21, 231 S.E.2d 298 (1977) (payment of loan commitment fees).

124. See text at note 114, *supra*.

125. See note 126, *infra*, and accompanying text.

126. See also *B. Kozolchvyk*, *supra* note 2, at 119-69. It should be recalled that in a sale-of-goods transaction, the issuing bank will be presented with several documents, among them the bill of lading. If the account party refuses to perform as per the contract with the issuer, the bill of lading allows the issuer to sell the goods and at least minimize its loss. The issuer has no such option in a standby credit situation.

However, the issuer should very carefully consider the propriety of this course of action. While custom and usage would seem to allow this conduct, the *ex parte* action on the part of the issuer might be a deprivation of property without due process of law insofar as the account party is denied the opportunity to a prior hearing to determine the validity of his refusal to perform under the contract. See *Fuentes v. Shevin*, 407 U.S. 67 (1972). Consequently, the account party might also have an action for deprivation of civil rights under 42 U.S.C. §§ 1981, 1983 (1977), in addition to a breach of contract action against the issuer. *But see Flagg Bros. v. Brooks*, 436 U.S. 149 (1978).

Note that one cannot correctly speak of the issuer in a documentary credit situation as being "secured" solely because he will come into possession of the bill of lading. In Louisiana there are only four types of security devices—pledge, mortgage, suretyship and privilege, and they are *stricti juris*, *i.e.*, strictly construed. See LA. CIV. CODE

In order to more fully understand the risks involved in issuing a standby credit, one must understand the relationships which arise, due to the issuance of the credit. The issuer is not a surety;¹²⁷ nor can he properly be classified as a solidary obligor.¹²⁸ A solidary obligor is given certain rights under the Civil Code which are clearly incompatible with the letter of credit format. For instance, if one solidary obligor makes payment to the creditor, the other solidary obligors are also released from liability to the creditor.¹²⁹ In a letter of credit context, however, regardless of what has transpired between the account party and the beneficiary, the issuer must pay upon compliance with the terms of the credit.¹³⁰ Also, the solidary co-obligor who pays the debt can only seek contribution from the other co-obligors for their virile portion,¹³¹ while the issuer, by virtue of the contract with the account party should have a *right* to the full amount paid under the credit from the account party.

The issuer of a credit, particularly a standby credit, should

art. 3183 for the general rule that "[t]he property of the debtor is the common pledge of his creditors" If the issuer were in a position where it was critical that he be a "secured creditor," he could make the somewhat tenuous argument that the bill of lading was given by the debtor's agent, the beneficiary, in order to secure the debt and it is therefore a pledge. See LA. CIV. CODE art. 3133. Compare the security device provisions of the Civil Code with article 9 of the U.C.C. See also J. WHITE & R. SUMMERS, *supra* note 1, at 730; Sachse, *Report to the Louisiana Law Institute on Article Nine of the Uniform Commercial Code*, 41 TUL. L. REV. 505 (1967).

127. See text at note 38, *supra*. Since the relationship of the issuer is not one of suretyship, the issuer cannot take advantage of the subrogation rights of a surety who pays the principle obligation. See LA. CIV. CODE arts. 3052, 3053. For very similar reasons the surety has no indemnity action against the debtor (account party) under article 3057. Article 3057 by its terms is applicable only to sureties. Beyond this, article 3057 assumes that the obligations of the debtor and the surety are directly related to the debtor-creditor obligation. For example, the surety has the right to assert non-personal defenses of the debtor when sued on the obligation. In the letter of credit transaction, the issuer-beneficiary relationship is wholly independent and separate from either the issuer-account party or the account party-beneficiary relationships. See text at note 45, *supra*.

128. LA. CIV. CODE art. 2082 states:

When several persons obligate themselves to the obligee by the terms *in solido*, or use any other expressions, which clearly show that they intend that each one shall be separately bound to perform the whole of the obligation, it is called an obligation *in solido* on the part of the obligors[.]

129. LA. CIV. CODE art. 2091.

130. See text at note 51, *supra*.

131. LA. CIV. CODE art. 2103.

realize that upon payment under the credit the issuer simply becomes an unsecured creditor of the account party unless the issuer-account party contract gives the issuer some protection. The issuer should protect himself by executing a security contract with the account party. Several options are available to the issuer who agrees to issue a standby credit. The most desirable solution to the issuer would be to require the account party to place with the issuer, in advance, a sum of money or other highly liquid assets in an amount equal to the issuer's maximum liability.¹³² While there may be circumstances in which the account party will find this agreeable,¹³³ generally in a standby credit transaction the account party needs a credit to secure some other form of financing and will not have the capital available to place with the issuer. The solution most likely to satisfy both the issuer and the account party will be a contract of reimbursement and the simultaneous execution of one or more promisory notes by the account party to the issuer, the notes being secured by either a chattel or conventional mortgage on the account party's property. The notes will generally have an acceleration clause which will mature the note upon the issuer's payment under the credit.

Standby Letters of Credit and National Banks

Because banks are generally the parties which issue letters of credit on a regular basis, and because the federal regulations which overlay the issuance of credits by national banks are very complex, this section will deal with the particular requirements and problems which a national bank must face in issuing standby letters of credit. National banks are authorized to issue letters of credit of all types governed by the Uniform Commercial Code or the Uniform Customs and Practice for Documentary Credits (U.C.P.),¹³⁴ subject to five criteria for

132. To similar effect is the frequent contract provision that the account party will keep a sufficient balance in his checking account to cover the issuer's maximum or potential liability under the credit—the so-called "compensating balance." The problem with this from the issuer's viewpoint is that the balance may inadvertently fall below the issuer's limits of liability under the credit.

133. This arrangement is generally more acceptable in the sale-of-goods transaction where the buyer could pay cash for the goods, but wishes to receive the benefit of the issuer's knowledge and experience in this complex area of trade.

134. 12 C.F.R. § 7.7016 (1978) (effective May 12, 1977).

safe and sound banking practice regarding issuance of letters of credit.¹³⁵

The first federal regulatory criterion is that the credit can be issued by the bank only to or on behalf of the bank's customer.¹³⁶ It may be of some importance to note that the Comptroller did not define "customer" in the regulation. Should the issuer take a very restrictive approach and assume that only one who has a checking account, a savings account, or other consistent business contacts with the issuer is a customer for the purposes of regulation, or is a less restrictive view of the definition preferable? Since the regulation generally approves credits issued under either the U.C.C. or the U.C.P., the writer suggests the adoption of the U.C.C. definition of customer, "a buyer or other person who causes an issuer to issue a credit [or] a bank which procures issuance or confirmation on behalf of that bank's customer."¹³⁷ The breadth of such a definition would surely facilitate letter of credit transactions.

The second criterion of the regulation is that the letter of credit conspicuously state that it is a letter of credit or at least be conspicuously entitled a letter of credit.¹³⁸ This requirement adds nothing to the bank's duty, as the language merely tracks the definition of a letter of credit under section 5-102.¹³⁹

The regulation's third criterion is that the bank's undertaking, *i.e.*, issuance of the credit, contain a specified expiration date or be limited to a definite period of time.¹⁴⁰ This presents no problems where the bank does single, infrequent transactions for a customer. However, it is conceivable that a customer could have a long-term supply contract with the ben-

135. *Id.* It is arguable that the five criteria set out by the Comptroller in 12 C.F.R. § 7.7016 are only guidelines for safe and sound banking practice and not definitional of such practices with regard to the issuance of letters of credit. However, a finding that a bank is conducting or engaging in unsafe and unsound banking practices has such dire consequences that few banks are likely to disregard § 7.7016. For example, under the Federal Deposit Insurance Act, 12 U.S.C. § 1818 (1977), a state member bank or a national bank can be required to cease and desist from unsafe and unsound practices and have its insured status withdrawn and be placed in receivership. See J. WHITE, *BANKING LAW* 717-59 (1976).

136. 12 C.F.R. § 7.7016 (1978).

137. U.C.C. § 5-103(1)(g) (1972 version). See also note 148, *infra*.

138. 12 C.F.R. § 7.7016(a) (1978). See note 100, *supra*.

139. U.C.C. § 5-102 (1972 version).

140. 12 C.F.R. § 7.7016 (1978).

eficiary in which the mode of payment is by letter of credit upon performance, or the customer might have a continuous contract with the beneficiary which requires periodic or multiple performance bonds and the parties might agree that a letter of credit will be substituted for the bond. In these instances it is desirable for the parties to execute a single credit that allows multiple transactions to take place between the customer and the beneficiary without execution of a new credit for each transaction.

The credit can be drafted so that it complies with the definite term requirement yet allows sufficient flexibility to the parties. There appears to be no prohibition against issuing a letter of credit which contains an expiration clause such as the following:

This letter of credit is to expire one year from the date of issuance and is hereby to be automatically extended without further amendment or action by the parties for one year from any present or future expiration date, unless the issuer notifies the beneficiary hereof thirty days prior to such present or future expiration date that this letter of credit shall not be extended, provided further that nothing herein shall authorize the extension of this letter of credit beyond (some date several years in the future).¹⁴¹

The fourth criterion is that the bank's obligation should be limited in amount and its obligation to pay should arise only upon the presentation of a draft or other documents specified in the letter of credit.¹⁴² Prior to the 1977 amendment to section 7.7016 this requirement was the basis of some speculation as to the validity of a standby credit issued by a national bank because the section stated that: "the bank's obligation to pay must arise only upon the presentation of *specific documents*"

141. See *National Sur. Corp. v. Midland Bank*, 551 F.2d (3d Cir. 1977), where a similar extension clause was at issue under a credit opened by a New Jersey State Bank. The court felt that the governing statute, N.J. REV. STAT. 17:9A-25(3) (1948), was designed to place state banks at parity with national banks with respect to duration of credits. Thus the court interpreted the statute to allow a letter of credit issued by a state bank to extend for periods of *more* than one year and held that the statute merely prohibited the drafts drawn under the credit remaining negotiable for more than one year.

142. 12 C.F.R. § 7.7016 (1978).

specified in the letter of credit.¹⁴³ Since often the only "document" required under a standby credit is a statement by the beneficiary that the underlying obligation is in default and he is entitled to draw under the credit,¹⁴⁴ some banks construed the language as applicable only to documentary credits in a sale-of-goods transaction.¹⁴⁵ The 1977 amendment to section 7.7016 revised the phrase to read "draft or other documents"¹⁴⁶ This should be viewed as a specific recognition by the Comptroller of the Currency of the widespread use of the standby letter of credits in modern banking and as his sanction for their use.

The regulation also reinforces a basic tenet of letter credit law: the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary.¹⁴⁷ The Comptroller's position on this principle is well founded; apparently it is also very strong since this criterion and the criterion that a credit only be issued to or on behalf of a customer, are the only ones phrased in mandatory language.¹⁴⁸

The final requirement of section 7.7016 is that the bank's customers have an unqualified obligation to reimburse the bank for payments made under the letter of credit.¹⁴⁹ This section is satisfied if at the time of the issuance of the credit the customer agrees, usually by execution of a promissory note, to repay the issuer for drafts drawn and paid under the credit. This requirement evidences the Comptroller's acceptance of a basic concept in letter of credit law: the bank's obligation to pay depends solely upon the presentation of complying documents, and subsequent developments in the underlying trans-

143. 12 C.F.R. § 7.7016 (1972) (as it appeared prior to the 1977 amendment) (emphasis added).

144. See *Bossier Bank & Trust Co. v. Union Planters Nat'l Bank of Memphis*, 550 F.2d 1077 (6th Cir. 1977), discussed in the text at note 70, *supra*.

145. See COMPTROLLERS INTERPRETIVE RULING ON LETTERS OF CREDIT, 42 Fed. Reg. 24206 (1976) (Revised).

146. *Id.*, codified in 12 C.F.R. § 7.7016 (1978).

147. See the text at note 69, *supra*.

148. 12 C.F.R. § 7.7016 (1978). Furthermore, this is the only time in § 7.7016 that the term "account party" is used instead of customer. Does this requirement contemplate a different class of persons than is contemplated by the use of the word customer in the U.C.C.? Neither the cases nor statutes provide an answer.

149. 12 C.F.R. § 7.7016 (1978).

actions and obligations are irrelevant.¹⁵⁰

While section 7.7016 generally recognizes all letters of credit which can be issued under the U.C.C. or the U.C.P.,¹⁵¹ the Comptroller has expressly defined a standby letter of credit as follows:

A "standby letter of credit" is any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer 1) to repay money borrowed by or advanced to or for the account of the account party or 2) to make payment on account of any indebtedness undertaken by the account party, or 3) to make payment on account of any default by the account party in the performance of an obligation.¹⁵²

The standby letter of credit, according to this definition, does not include the commercial letter of credit "and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer, which do not 'guaranty' payment of a money obligation and which do not provide for payment in the event of default by the account party."¹⁵³

One may reasonably wonder why the Comptroller has given special attention to the standby credit rather than treating it with other types under the general letter of credit authorization.¹⁵⁴ The answer is twofold. First, letters of credit generally and standby letters of credit particularly are considered as being in the nature of a loan for purposes of determining a bank's lending limit.¹⁵⁵ Thus the maximum potential liability

150. See text at note 36, *supra*.

151. See note 134, *supra*, and accompanying text.

152. 12 C.F.R. § 7.1160 (1978).

153. *Id.* at n.1.

154. 12 C.F.R. § 7.7016 (1978).

155. 12 C.F.R. § 7.1160 (1978) provides as follows: "(b) Subject to lending limits.

A standby letter of credit is subject to the limitations of section 84 and must be combined with any other non-expected loans to the account party by the issuing bank for the purpose of applying section 84."

Although there are no reported cases which deal with this issue, it seems logical to assume that if a standby credit requires the issuing bank to accept the presented draft, then the transaction is no longer governed by the standby credit regulations but rather by the banker's acceptance regulations. See 12 C.F.R. §§ 7.1500-.1630. Of course it is doubtful that the acceptances generated by the standby credit would fall within one of those exceptions.

of the issuer bank under the standby letter of credit enters into the calculation of whether the total obligations of any one person, partnership, corporation, etc. to the national bank exceed 10% of its unimpaired, paid-in capital stock and 10% of its unimpaired surplus.¹⁵⁶ Secondly, standby letters of credit are considered as contingent liabilities of the bank and must be reported as a general note to the balance sheet.¹⁵⁷ However, there are three situations in which the standby letter of credit is not subject to the provision of title 12, section 84, of the United States Code. These exceptions occur if:

- a) prior to or at the time of issuance, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit;¹⁵⁸ or
- b) prior to or at the time of issuance, the issuing bank has set aside sufficient funds in a segregated deposit account, clearly earmarked for that purpose, to cover the bank's maximum liability under the standby letter of credit;¹⁵⁹ or
- c) the Comptroller of the Currency has found that a particular standby letter of credit will not expose the issuer to the similar risk of loss as would a loan to the account party.¹⁶⁰

Prior to the May 12, 1977 amendment to section 7.7016, several cases arose in which the defendant bank in a suit for wrongful dishonor argued that dishonor was justified because the standby credit it had issued was a guaranty which was beyond the power of the bank to lawfully issue. With general uniformity the courts distinguished a prohibited guaranty from the standby credit by noting that a guarantor is a secondary obligor, whereas the issuer of a credit is a primary obligor.¹⁶¹ No

156. 12 U.S.C. § 84 (1972). The purpose of this provision is to increase stability of banks by spreading the risks among many borrowers rather than allowing a small number of borrowers to utilize a large portion of the deposits. 12 C.F.R. § 7.1310 (1978).

157. 12 C.F.R. § 11.7(c)(9)(vii) (1978).

158. Under 12 C.F.R. § 204.104 (1978), the Comptroller has ruled that these cash collateral accounts are considered a deposit against which a Federal Reserve member bank must maintain adequate reserves. See 12 U.S.C. § 461 (1974).

159. 12 C.F.R. § 7.1160(c) (1978).

160. *Id.*

161. *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1124 (5th Cir. 1973); *Prudential Ins. Co. of America v. Marquette Nat'l Bank of Minneapolis*, 419 F. Supp. 734 (D. Minn. 1976); *Hyland Hills Metropolitan Park and Recreational Dist. v.*

cases were found in which this argument was based on the May 12, 1977 amendment to section 7.7016. This is not surprising since the amendment, if anything, should reinforce the position previously taken by most courts.

The Comptroller's 1977 amendment to section 7.7016 may have additional significance because of what it did not state. The Comptroller could have taken a very firm position against standby letters of credit by allowing only those letters of credit which were permissible under either the U.C.C. or U.C.P. and conformed to the five criteria listed. The effect of such a ruling would surely have caused national banks to adopt very conservative standby credit issuance policies. However, by providing that national banks can issue any credits allowable under the U.C.C. or U.C.P., subject only to standards for safe and sound banking practice, the Comptroller has taken a rather liberal view toward standby credits. The conspicuous absence of litigation challenging the national banks' authority to issue standby credits which do not meet the five criteria indicates the financial community's acceptance of the interpretation. Banks will no doubt take a conservative stance with regard to the criteria in section 7.7016. However, the fact that these criteria are to be used only in determining whether a bank is conducting safe and sound banking practices¹⁶² indicates to this writer an official sanction for the use of standby credits and also should provide an impetus for expansion of that use.

Conclusion

Letters of credit are becoming increasingly more important in commerce and industry. No longer is the function of the letter of credit limited to the traditional sale-of-goods context. Rather, the increased acceptance and use of transferable and back-to-back credits have added increased flexibility and utility to such traditional sale-of-goods transactions. In addition to the use of the letter of credit to accomplish a mere payment

McCoy Enterprises, Inc., 554 P.2d 708 (Colo. Ct. App. 1976). *Contra*, Wichita Eagle and Beacon Pub. Co., Inc. v. Pacific Nat'l Bank of San Francisco, 493 F.2d 1285 (9th Cir. 1974), in which the court recognized the expanding role of letters of credit as financing devices, but refused to follow those decisions distinguishing standby credits from guaranties.

162. See 12 C.F.R. § 7.7016 (1978).

function, the standby letter of credit and the transferable credit are beginning to accomplish an important financing function as an alternative to performance bonds and guarantees. Since the authority and scope of national banks to issue letters of credit have largely been resolved, the Bench and Bar will become more familiar with letters of credit and more accustomed to their use. Indeed, this flexible financial device may one day become as accepted among practitioners as guarantees and suretyships are now. All that remains is for the ingenuity of the practitioner to devise new and different uses for letters of credit.

David Richard Taggart