Denver Journal of International Law & Policy

Volume 9
Number 1 *Winter*

Article 13

May 2020

Letters of Credit - American Company Failed to Prove the Elements Necessary to Warrant a Preliminary Order Enjoining an American Bank from Making Payment under a Letter of Credit to an Iranian Bank, Even Though, as a Result of the Islamic Revolution, the Iranian Government Might Default on a Consulting Services Contract with the American Compapny

Dirk T. Biermann

LETTERS OF CREDIT—AMERICAN COMPANY FAILED TO PROVE THE ELEMENTS NECESSARY TO WARRANT A PRELIMINARY ORDER ENJOINING AN AMERICAN BANK FROM MAKING PAYMENT UNDER A LETTER OF CREDIT TO AN IRANIAN BANK, EVEN THOUGH, AS A RESULT OF THE ISLAMIC REVOLUTION, THE IRANIAN GOVERNMENT MIGHT DEFAULT ON A CONSULTING SERVICES CONTRACT WITH THE AMERICAN COMPANY. *American Bell International, Inc. v. Islamic Republic of Iran,* 474 F. Supp. 420 (S.D.N.Y. 1979).

On July 23, 1978 the Imperial Government of Iran (Imperial Government) entered into an agreement for international communications consulting services and equipment with American Bell International (Bell), a wholly-owned subsidiary of American Telephone and Telegraph. This agreement permitted the Imperial Government to demand the return of its 38.8 million dollar down payment at any time (with the exception of twenty per cent of the amounts actually invoiced by Bell and approved by the Imperial Government). In order to secure the return of the down payment on demand, Bell was required to establish an irrevocable and unconditional letter of guaranty in favor of the Imperial Government through the Iranian Bank Iranshahr. This letter, in turn, was guaranteed by a letter of credit issued by an American bank, Manufacturers Hanover Trust Company (Manufacturers). Bell agreed to reimburse Manufacturers for all amounts that might be paid pursuant to this letter of credit.

Following the Islamic revolution in Iran, Bell filed suit in U.S. District Court in New York seeking to enjoin Manufacturers from making payment on the letter of credit. Bell, which had stopped performance on the contract in January 1979, claimed that the contract had been breached by the Imperial Government and repudiated by the Islamic Republic of Iran in that Bell was owed a substantial amount of money for services rendered under the contract and its termination provisions.[1]

The court denied Bell's motion for a preliminary injunction. As set forth in *Caulfield v. Board of Education,*[2] four requirements must be satisfied before the court may grant injunctive relief. "There must be a showing of possible irreparable injury and either (1) probable success on the merits or (2) sufficiently serious questions going to the merits to make them fair ground for litigation and a balance

1. 474 F. Supp. at 422.
2. 583 F.2d 605 (2d Cir. 1978).

of hardships tipping decidedly toward the party requesting the preliminary relief."[3] The court found that Bell failed to establish facts sufficient to meet these requirements.

Bell fell short of establishing possible irreparable injury because it had available adequate remedies at law. First, Bell would have an action for money damages if Manufacturers paid Bank Iranshahr on the letter of credit in violation of its terms. Second, while the court admitted that Bell no longer had any meaningful access to the courts of Iran (the agreement provided that Iranian law should govern the settlement of disputes arising under the contract), the company was not precluded from bringing an action in U.S. courts under the Sovereign Immunities Act.[4]

Bell failed to prove probable success on the merits in that it could not prove by a preponderance of the evidence that either (1) demand under Manufacturers' letter of credit did not conform to the terms of that letter, or (2) that the demand, having been properly made, should not be honored because of "fraud in the transaction." The court first considered the nonconformity issue. The demand for payment by Bank Iranshahr was identical to the terms of the letter of credit in every respect but one. The letter of credit named as payee the "Imperial Government of Iran Ministry of War," whereas the demand for payment named as payee the "Government of Iran Ministry of Defense, Successor to the Imperial Government of Iran Ministry of War."[5] The court found that, although a demand for payment must strictly comply with the letter of credit in order to justify payment,[6] a court, upon a full trial, would probably not find nonconformity in this case. As legal successor to the Imperial Government, recognized as such by the United States,[7] the Government of Iran could properly demand payment under the terms of the letter of guaranty which provided for payment to the Government of Iran's

---

3. *Id.* at 610.

4. 28 U.S.C. § 1605(a)(2) (1976) provides, *inter alia*, that a foreign state shall not be immune from jurisdiction of U.S. courts in any case in which the action is based upon a commercial activity of a foreign state conducted outside the territory of the United States which causes a direct effect in the United States. 28 U.S.C. § 1610(b)(2) (1976) allows attachment of property in the United States belonging to the foreign state in aid of execution upon a judgment obtained under § 1605(a)(2).

5. 474 F. Supp. at 423.

6. *See, e.g.*, Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 465 (2d Cir. 1979); North American Foreign Trading Corp. v. General Electronics, Ltd., 67 A.D. 2d 890, 413 N.Y.S.2d 700 (1979); Key Appliance, Inc. v. First National City Bank, 46 A.D.2d 622, 359 N.Y.S.2d 866 (1974), *aff'd*, 37 N.Y.2d 826, 339 N.E.2d 888, 377 N.Y.S.2d 482 (1975).

7. 474 F. Supp. at 423-24.

predecessor.[8]

Bell's primary contention, and the issue given the most consideration by the court, was that payment on the letter of credit should have been enjoined because the Islamic Republic was guilty of "fraud in the transaction." The argument between the parties focused on the scope to be given the term "transaction." Manufacturers contended that the term referred only to the letter of credit transaction and not to the underlying commercial transaction. Bell argued that the term referred to the totality of circumstances.

Fraud in the transaction was first allowed as a theory of relief in *Sztejn v. Henry Schroder Banking Corp.*[9] The case involved a letter of credit secured to guarantee payment for bristles purchased by a New York merchant from a supplier in India. The plaintiff successfully argued that the shipping of cowhair and other useless material constituted fraud justifying enjoining payment under the letter of credit. Since the materials shipped were not the materials ordered, the shipping documents which were required to be presented for payment under the letter of credit were fraudulent and therefore payment was not due under the terms of the letter. While the court in *Sztejn* reaffirmed the independence of the letter of credit from the underlying contract, it also introduced the notion that the underlying transaction could be considered in determining whether documents essential for payment under the letter of credit were in fact fraudulent even though conforming on their face to the requirements of the instrument.

The Uniform Commericial Code of New York, which the parties agreed was controlling in this case, attempted to codify the "fraud in the transaction" terminology in section 5-114.[10] The Code allows an issuer of a letter of credit the option to deny payment to the beneficiary when there is fraud in the transaction and the beneficiary is not a holder in due course. The Code implies that a court of appropriate jurisdiction can enjoin an issuer from honoring demand on a letter of credit on a finding of "fraud in the transaction." However, the Code does not clarify whether fraud in the transaction pertains only to the letter of credit transaction or to the underlying contract between the issuer's customer and the beneficiary of the letter of credit,[11] and cases since *Sztejn,* both before and after the section 5-114 addition

8. *See* Pastor v. National Republic Bank, 56 Ill. App.3d 421, 371 N.E.2d 1127 (1977), *aff'd,* 76 Ill.2d 139, 390 N.E.2d 894 (1979).

9. 177 Misc. 719, 31 N.Y.S.2d 631 (1941).

10. N.Y.U.C.C. § 5-114(2)(McKinney)(1964).

11. *See* 63 MINN. L. REV. 487, 508 (1979).

to the Code, are not consistent as to the proper interpretation of the phrase.

The court did not determine which interpretation should be given effect because it felt that, on either theory, Bell had not demonstrated probable success on the merits. The court considered Bell's allegations that the Islamic Republic had taken actions to repudiate all its contracts with American companies, but dismissed these allegations as unproved. The court also held that Bell failed to demonstrate "the kind of evil intent necessary to support a claim of fraud" or that the actions of the Islamic Republic in its purported repudiation were made with "fraudulent intent to mulct Bell."[12]

Although the court did find that these issues involved sufficiently serious questions going to the merits to make them fair ground for litigation, it failed to find that the balance of hardships tipped decidedly toward the plaintiff Bell. Even though Bell stood to lose a substantial sum of money, Manufacturers stood to lose as much or more if the letter of credit it had issued was not honored. Manufacturers held many assets in Iran that could be subject to nationalization by the Iranian Government or to attachment by Iranian courts in proceedings initiated by Bank Iranshahr, and Manufacturers could lose credibility in the international banking community if it failed to make good on its letter of credit. Moreover, Bell knowingly and voluntarily entered into the contract which allowed the Iranian Government to recoup its down payment on demand in order to bring to Bell "both monetary profit and prestige and good will in the global communications industry."[13] Bell sought the benefits of this commercial arrangement and the court felt that it must also bear the burdens.

While the result of the *Bell* case seems to support the independent nature of the letter of credit, the dicta in the decision indicates a willingness on the part of the court to entertain arguments relating to fraud occurring in the underlying transaction which does not directly affect the letter of credit transaction. The court suggests that if the demand for payment was made with the intent to defraud or penalize Bell in its attempt to settle disputes through enforcement of the underlying contract and its termination provisions, a court could properly enjoin payment on the letter of credit which was established to guarantee that payment on demand.

The utility of the letter of credit in international trade is depen-

12. 474 F. Supp. at 425.
13. *Id.* at 426.

dent on its continued independence from the underlying agreement. By allowing greater recognition of the underlying transaction in actions to enjoin payments under letters of credit the courts threaten this utility. The end result is a greater burden on international trade as parties to agreements are less able to rely on the guarantee of payment the letter of credit is designed to secure.

If the trend to consider the underlying transaction as an integral part of the letter of credit transaction continues, especially in cases such as this one, where an American company has agreed to be bound by the laws of a foreign jurisdiction, the willingness of foreign corporations and governments to enter into agreements with U.S. parties will be impaired. Such a move, not unlike the freeze on Iranian assets in the United States, would do little to raise the confidence of foreign businesses and governments in the American business system.

Dirk T. Biermann