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LETTERS OF CREDIT: A PRIMER

CHRISTOPHER LEON*

I. INTRODUCTION

Letters of credit are used to facilitate marketplace transactions by providing the credit of a third party, generally a bank, as an independent assurance of payment to protect parties to commercial agreements. They are also useful as a financing mechanism to allow parties holding such credits to produce or obtain commodities to be sold. The critical feature of a letter of credit is its reliability, i.e., its certainty of payment. Hence, parties who might otherwise hesitate to enter into a transaction are encouraged to participate because they can rely upon a secure source of credit and thereby more accurately assess the possible risks in the undertaking.[1]

The letter of credit has traditionally been associated with international transactions but is being used with increasing frequency in domestic transactions. Although its use dates back centuries, there is limited case law, and little attention is given the subject in an attorney's formal education. Nevertheless, letters of credit deserve the practitioner's consideration since they may be used as creative solutions to problems that might otherwise prevent a transaction. In using this device, however, the practitioner should give careful attention to the governing law. The letter of credit is a specialized document and therefore a small "technical" error may strip it of its reliability and result in financial disaster to the attorney's client.

The purpose of this article is to acquaint practitioners with the letter of credit, suggest some of its potential uses, and point out pitfalls of a letter of credit transaction. The article will briefly review the historical development of letters of credit and identify the parties to a typical credit transaction. It will then focus on the various types of letters of credit and their features, the bodies of law governing their use, and the respective obligations of parties involved.

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1. The purpose of this article is not only to familiarize readers with the attributes and uses of letters of credit, but to suggest that their reliability is crucial. Any attempt to diminish this aspect will limit their commercial usefulness vis-à-vis standard credit transactions. For a summary of the advantages of a letter of credit, see *infra* notes 174-76 and accompanying text.

A. *Historical Development of Letters of Credit*

Letters of credit can be traced at least as far back as the twelfth century.[2] Originally, they were two-party arrangements whereby a powerful or wealthy individual issued a letter promising payment in order to induce a merchant to deliver goods or advance money to that individual's servant or agent.[3] They were similarly used between merchants themselves, with the reliability factor supplied by the closeness of the merchant network.[4]

The present form of a letter of credit is significantly different. Given the expanded commercial arena and the larger magnitude of commercial transactions, the reputation of an individual principal is often not sufficient to induce another to perform a service or deliver a product. Accordingly, the merchant will seek the credit of an independent party, usually a bank,[5] whose larger and more secure resources obviate the need to inquire into the creditworthiness of a remote or unknown buyer. The modern letter of credit has thus introduced a new, third party to the transaction. However, its central purpose remains the same, i.e., it provides a mechanism under which the credit of one party is made available to another, thereby assuring payment and facilitating the underlying transaction.

B. *Parties to a Letter of Credit*

1. The Customer, Beneficiary, and Issuer.—The essential parties to the letter of credit and the basic scheme of obligations among them are set out in the following example.

> Buyer and Seller enter into a contract for the sale of goods. The agreement includes a term whereby Buyer agrees to establish a letter of credit with a Bank in the amount of the

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2. For a more detailed discussion of the historical development of letters of credit, see Trimble, *The Law Merchant and the Letter of Credit*, 61 HARV. L. REV. 981 (1948) and Miller, *Problems and Patterns of the Letter of Credit*, 1959 U. ILL. L.F. 162, 162-66 (1959).

3. Miller, *supra* note 2, at 162-63.

4. A seventeenth century writer described such an operation as follows:

> A merchant doth send his friend or servant to buy some commodities or take up money for some purpose and doth deliver unto him an open letter, directed to another merchant, requiring him that if his friend . . . the bearer of that letter have occasion to buy commodities or take up monies that he will procure him the same and he will provide him the money or pay him by exchange.

MALYNES, LEX MERCATORIA 76 (1st ed. 1622), *as quoted in* Miller, *supra* note 2, at 163 n.6.

5. Although banks and savings and loan associations are the most frequent issuers of letters of credit, a person or organization other than a bank may be an issuer as well. MD. COM. LAW CODE ANN. § 5-102(b),(c) (1975).

purchase price. The Bank issues such a credit letter promising to pay Seller upon presentation of a draft and appropriate documents specified in the letter. Seller performs its obligations, and in so doing, gathers the necessary documents, e.g., bills of lading from the carrier, invoices, and inspection certificates. Seller presents the complying documents and the Bank honors the draft for payment. Buyer reimburses the Bank, takes the documents to the Carrier, and gets the goods.

In letter of credit terms, Buyer is the "customer," Seller is the "beneficiary," and the Bank is the "issuer."[6] Since there are three parties to a basic letter of credit transaction, there are three sets of obligations at issue.

a) The agreement between the *customer* and the *beneficiary*, that calls for the letter of credit, is the underlying contract for goods or services. This contract is governed by the substantive law of the jurisdiction and is independent of the rights and obligations generated by the letter of credit.

b) The obligation between the *issuer* and the *beneficiary* is the letter of credit itself. It is governed by the Uniform Commercial Code (U.C.C. or Code)[7] and the Uniform Customs and Practice for Documentary Credits (U.C.P.),[8] as well as the terms of the letter of credit. Although the issuer's obligation to the beneficiary is not technically a contract,[9] the issuer has a duty to pay the beneficiary once the beneficiary satisfactorily performs under the letter of credit

6. Definitions are found at MD. COM. LAW CODE ANN. § 5-103(1) (1975):

(c) An "issuer" is a bank or other person issuing a credit.

(d) A "beneficiary" of a credit is a person who is entitled under its terms to draw or demand payment

(g) A "customer" is a buyer or other person who causes an issuer to issue a credit. The term also includes a bank which procures issuance or confirmation on behalf of that bank's customer.

Obviously, a "customer" is not necessarily a buyer in a transaction, nor is a "beneficiary" always a seller. They have been identified as such in the example merely as an illustration of a simple and fairly typical letter of credit operation.

7. Article 5 of the U.C.C. (1977) addresses the letter of credit and has been adopted with variations in all fifty states, the District of Columbia, and the Virgin Islands. It is codified in Maryland at MD. COM. LAW CODE ANN. §§ 5-101 through -117 (1975 & Supp. 1985). For a discussion of governing law, see *infra* notes 31-54 and accompanying text.

8. INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (rev. ed. 1983). *See infra* notes 39-45 and accompanying text.

9. White and Summers in their treatise have recognized that the issuer's obligation to the beneficiary is not technically a contract since the issuer and beneficiary do not voluntarily enter into an agreement. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-2 (2d ed. 1980).

by presenting the documents identified therein.[10] In addition, the beneficiary warrants upon presentation of the documents that the necessary conditions of the letter of credit are satisfied.[11]

c) The establishment of a letter of credit between the *issuer* and the *customer* is not itself a contract since by statute no consideration is required.[12] However, these parties usually undertake a variety of contractual obligations. The agreement between the issuer and customer will certainly focus upon the customer's reimbursement of the funds extended by the issuer. In addition, the agreement will probably provide for the customer's payment of a fee for the issuer's service in providing the letter of credit. It may also specify the collateral provided by the customer to the issuer, and address the issuer's ability to accelerate the underlying debt or require the customer to prepay the debt.[13] The issuer can use these features to protect itself against a customer's default or bankruptcy[14]—an important consideration because while neither event

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10. MD. COM. LAW CODE ANN. § 5-114(1) (1975).

11. *Id.* § 5-111(1). Warranties given under this section are in addition to those arising under Articles 3, 4, 7, and 8 of the U.C.C. For example, the draft drawn on the issuer carries with it negotiable instrument warranties found in Article 3. Unless the parties agree otherwise, the beneficiary's warranty of compliance with the conditions of the credit is extended to all interested parties. *See id.* § 5-111 official comment.

12. *Id.* § 5-105.

13. The customer/issuer agreement may also define the customer's opportunity to review documents and respond to the issuer's inquiries, identify the issuer's obligation to the customer regarding document review, and require the customer's instructions to be in writing. Note, however, that under basic U.C.C. principles, MD. COM. LAW CODE ANN. § 1-102(3) (1975), the issuer may not disclaim its obligation of care in examination of documents. *See id.* § 5-109(2).

As a matter of sound banking practice the customer/issuer agreement should provide an unqualified obligation by the customer to reimburse the bank for payments made under the letter of credit. Comptroller of the Currency Interpretive Ruling, 12 C.F.R. § 7.7016(e) (1985).

14. *See* Ryan, *Letters of Credit Supporting Debt for Borrowed Money: The Standby as Backup,* 100 BANKING L.J. 404, 412-15 (1983). In addition, the issuer may share the risk of a particular transaction through a participation agreement with another institution, a back-up letter of credit, or a multibank credit. *Id.* at 416-21.

In a participation agreement, the issuer contracts with another party that in the event it must make payment under the letter of credit, the participating party will pay the issuer a specified percentage of such payment. In exchange, the issuer agrees to pay the participating party a percentage of the customer's payments under the reimbursement agreement. *Id.* at 416-18.

A back-up letter of credit is issued by an additional participant for the benefit of the issuer of the original letter of credit. This participant contracts directly with the customer of the original letter of credit, and thus may attempt to protect itself directly by obtaining adequate security. *Id.* at 418-20.

A multibank letter of credit involves the engagement of a number of different issuers obligated directly to the customer. It may take the form of (1) multiple letters of credit each issued by an individual issuer, (2) one credit issued by a number of issuers

discharges the issuer's obligation to the beneficiary,[15] the issuer's claim for reimbursement is subject to its customer's bankruptcy.[16]

Article 5 provisions of the U.C.C. oblige an issuer to exercise good faith, observe general banking usage, and examine documents with care to determine compliance.[17] Unless the issuer and customer otherwise agree, the issuer is not responsible for performance of the underlying contract or the falsification of any document that appears to be regular on its face.[18]

2. *Confirming, Advising, Paying, and Negotiating Banks.*—Letter of credit transactions may also include a number of intermediaries between the issuer and beneficiary. Of the four additional participants described below, only the "confirming" bank is itself obligated to the beneficiary under the letter of credit.

a) A "confirming bank" honors a letter of credit already issued by another bank or engages that the letter of credit will be honored by the issuer or a third bank.[19] The confirming bank is obligated to honor the letter of credit as if it were an issuer.[20] As a result, the beneficiary of a confirmed letter of credit has the independent obligations of both the issuer and confirming bank. A beneficiary can use the confirmation concept to secure the obligation of a bank in which it has confidence, or merely one located in

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who are liable for a specified percentage of the letter of credit, or (3) one letter of credit issued by a number of issuers who have appointed an agent to act on their behalf. *Id.* at 420-21.

15. *See In re* M.J. Sales & Distrib. Co., 25 Bankr. 608 (Bankr. S.D.N.Y. 1982); *In re* Page, 18 Bankr. 713 (Bankr. D.D.C. 1982). *Contra In re* Twist Cap, Inc., 1 Bankr. 284 (Bankr. D. Fla. 1979) (bankruptcy court enjoined bank from honoring standby letters of credit because the payment would constitute an impermissable preference). *In re Twist Cap* has been criticized by several commentators. *See, e.g.*, Comment, *The Standby Letter of Credit: What It Is and How to Use It*, 45 MONT. L. REV. 71 (1984) (when a bank customer files a bankruptcy petition, payment by the issuer of a letter of credit should not be enjoined as a preference because the credit is not an executory contract subject to rejection by the bankruptcy trustee, the debtor is not a party to the letter of credit or obligated thereunder, and the issuer pays the beneficiary with its own funds, not with the assets of the customer).

16. For a discussion of methods to limit an issuer's liability, see Saunders, *Preference Avoidance and Letter of Credit Supported Debt: The Bank's Reimbursement Risk In Its Customer's Bankruptcy*, 102 BANKING L.J. 240 (1985).

17. MD. COM. LAW CODE ANN. § 5-109(1), (2) (1975). A nonbank issuer is not bound by banking usage of which it has no knowledge. *Id.* § 5-109(3).

18. *Id.* § 5-109(1), (2).

19. *Id.* § 5-103(1)(f).

20. *Id.* § 5-107(2). Lustrelon, Inc. v. Prutscher, 178 N.J. Super. 128, 139, 428 A.2d 518, 524 (1981) (confirming bank is directly obligated under letter of credit to extent of confirmation).

the beneficiary's own locality.[21] Since a confirming bank undertakes direct obligations to the beneficiary, it acquires the rights of an issuer and may seek reimbursement from the customer.[22]

b) An "advising bank" gives the beneficiary notification of the issuance of a letter of credit.[23] Generally, it does not agree to honor a draft or demand for payment under the letter of credit[24] unless it is also a confirming bank. Should a bank inadvertently notify the beneficiary that it "confirms" a letter of credit instead of merely "advising" of its issuance, the bank is deemed to have undertaken the obligations of a confirming bank.[25] An advising bank is liable for its own errors in stating the terms of the letter of credit.[26] Notwithstanding an inaccurate advice of its terms, the letter of credit is established as against the issuer, but only to the extent of the original terms.[27]

c) A beneficiary may request that the issuer or confirming bank designate a "paying bank." The paying bank is merely a conduit for payment to the beneficiary and is usually selected on the basis of convenience. It is not itself liable under the letter of credit.[28]

d) A "negotiating bank" purchases drafts from the beneficiary at a discount and, in turn, presents them to the issuer.[29] The letter of credit here will contain a clause obligating the issuer to honor

21. Under Article 2 of the U.C.C., when a contract for the sale of goods calls for a confirmed letter of credit, it is presumed to mean confirmation by a financial agency in the seller's financial market. MD. COM. LAW CODE ANN. § 2-325(3)(1975). Note also that a bank can confirm a letter of credit issued by a nonbank. *See* Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1226 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974).

22. MD. COM. LAW CODE ANN. § 5-107(2) (1975).

23. *Id.* § 5-103(1)(e). Although technically the Code defines an advising bank as one giving notification of a letter of credit issued by another *bank*, courts will probably permit a bank to advise a beneficiary of a letter of credit issued by a nonbank. *Cf.* D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1226 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974) (bank can *confirm* letter of credit issued by nonbank).

24. MD. COM. LAW CODE ANN. § 5-107(1); Bamberger Polymers Int'l Corp. v. Citibank, N.A., 124 Misc. 2d 653, 655-56, 477 N.Y.S.2d 931, 932-33 (Sup. Ct. 1983) ("advising bank has no obligation beyond the transmission of accurate information").

25. D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1235 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974) (bank intended only to "confirm" authenticity of signatures and not to assume obligation to pay on letter of credit).

26. MD. COM. LAW CODE ANN. § 5-107(1) (1975).

27. *Id.* § 5-107(3).

28. International Corp. v. Citibank, N.A., 124 Misc. 2d 653, 655-56, 477 N.Y.S. 2d 931, 932-33 (Sup. Ct. 1983) (paying bank merely moves funds at issuer's direction). The paying bank may also be an advising bank. *Id.*

29. MD. COM. LAW CODE ANN. § 5-114(2)(a) (1975).

drafts from one who has purchased them from the beneficiary.[30] This arrangement may be useful to the beneficiary when the issuer is unable to engage a paying bank.

C. *Governing Law*

Letters of credit are governed primarily by two bodies of law: Article 5 of the U.C.C.;[31] and the U.C.P.[32] These two sources of law are complemented, as is the U.C.C. in general, by agreements of the parties, case law, and trade usage and custom.[33]

1. *Article 5 of the Uniform Commercial Code.*—Article 5 governs if: (1) the letter of credit is issued by a bank and requires a documentary draft or a documentary demand for payment; or (2) the letter of credit is issued by a person other than a bank and requires that the draft or demand for payment be accompanied by a document of title; or (3) the letter of credit is not within (1) or (2) but conspicuously states it is a letter of credit.[34]

Article 5 expressly states that it contains some but not all of the rules and concepts of letters of credit.[35] In fact, the text goes even further, stating that a rule in Article 5 does not by itself imply or negate its application in situations not covered by the Article.[36] The drafters of the Code, however, did not leave the courts without guidance. Section 1-201 requires a liberal interpretation of the Code to promote the underlying purposes and policies of the various articles. Consequently, interpretation of Article 5 should favor certainty of payment and, in general, should support the integrity of letter of credit transactions.[37]

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30. *See* Miller, *supra* note 2, at 191-92.

31. *See supra* note 7.

32. *See supra* note 8.

33. The intention of the drafters in writing Article 5 of the U.C.C. was "to set an independent theoretical frame for the further development of letters of credit," rather than attempt to define statutorily all possible uses and characteristics. MD. COM. LAW CODE ANN. § 5-101 official comment (1975).

34. MD. COM. LAW CODE ANN. § 5-102 (1975). Note that a credit may meet the requirements of the first two categories regardless of whether it is expressly labeled a letter of credit.

35. MD. COM. LAW CODE ANN. § 5-102(3) (1975). Specific matters, such as what constitutes documentary compliance with the terms of a letter of credit, or what effect the absence of an expiration date has, are left to judicial determination. *Id.* § 5-102 comment 2.

36. *Id.* § 5-102(3).

37. Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank, 571 F.2d 871, 874 (5th Cir. 1978).

A second consideration in construing the U.C.C. is that a significant number of the sections and subsections in Article 5 are preceded by the words "unless otherwise agreed." Thus, parties can draft a letter of credit to fit the particular circumstances of their transaction.[38] Consequently, although a letter of credit may seem particularly susceptible to being issued in the "usual form," with the customary boilerplate, it can and should be carefully prepared to reflect the parties' needs, as well as to protect the interests of the issuer.[39]

2. *Uniform Customs and Practices.*—Most international letters of credit and an increasing number of domestic credits are, by their terms, subject to the U.C.P. The U.C.P. was drafted by the International Chamber of Commerce, Commission on Banking Technique and Practice, to promote international trade by establishing uniform standards of practice.[40] Courts however, find the U.C.P. helpful in interpreting all letters of credit, whether or not expressly incorporated in the letter itself, by regarding it as evidence of trade usage and custom.[41] In this sense the U.C.P. is an important adjunct to Article 5 which, as noted above, is intended to state only the fundamental theories underlying letters of credit. In addition, New York, Missouri, Alabama, and Arizona, have adopted a modified version of section 5-102 of the U.C.C.[42] that provides:

> (4) Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth or by any subsequent Congress

38. *See* Comment, *"Unless Otherwise Agreed" and Article 5: An Exercise in Freedom of Contract*, 11 ST. LOUIS U.L.J. 416 (1967).

39. *See* Del Duca, *Pitfalls of "Boiler Plating" Letters of Credit*, 13 U.C.C. L.J. 3 (1980-81). *See also* East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co., 593 F.2d 598 (5th Cir. 1979) (issuer's attempt to draft standby letter of credit on commercial letter of credit form created ambiguities which the court interpreted against issuer).

40. The U.C.P. was first adopted in 1933 in Vienna at the International Chamber of Commerce's Seventh Congress. It has since been revised four times in an attempt to keep abreast of technological, financial, and documentary changes respecting international trade. The most recent edition was approved on June 2, 1983, and effective October 1, 1984. INTERNATIONAL CHAMBER OF COMMERCE, PUBLICATION NO. 400 (1983).

41. *See* Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 388 n. 5 (D.Md. 1982), *aff'd*, 704 F.2d 136 (4th Cir. 1983) (using U.C.P. as evidence of custom and usage).

42. Section 5-102 addresses the scope of Article 5. *See supra* text accompanying note 34.

of the International Chamber of Commerce.[43]

A literal construction of section 5-102(4) would suggest that Article 5 is inapplicable to a letter of credit that refers to the U.C.P.[44] However, some courts in states applying section 5-102(4) have held the U.C.P. applicable only when it is in direct conflict with the U.C.C.[45] Courts in other states, when construing a credit that expressly incorporates the U.C.P., should also apply it only when it is in direct conflict with the U.C.C.[46] When the parties do not expressly incorporate the U.C.P., it may of course be used as evidence of trade usage or custom, but it will not prevail over the U.C.C. when they are in conflict.[47]

3. *Interpretation of the Letter of Credit.*—Despite the issuer's attempts to draft a letter of credit with clarity, questions of interpretation inevitably arise. General contract principles and custom and

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43. U.C.C. § 5-102, 2A U.L.A. 226 (1977).

44. *See* Merchants Bank v. Credit Suisse Bank, 585 F. Supp. 304 (S.D.N.Y. 1984) (§ 5-102(4) displaces application of U.C.C.); Shanghai Commercial Bank, Ltd. v. Bank of Boston Int'l, 53 A.D.2d 830, 385 N.Y.S.2d 548 (App. Div. 1976); Capehart Corp. v. Shanghai Commercial Bank Ltd., 49 A.D.2d 521, 369 N.Y.S.2d 751 (App. Div. 1975) (dictum).

45. *See, e.g.*, Prutscher v. Fidelity Int'l Bank, 502 F. Supp. 535 (S.D.N.Y. 1980); United Bank, Ltd. v. Cambridge Sporting Goods Corp., 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976) (dictum suggesting U.C.P. should not prevent court adoption of U.C.C. rule as long as latter supported by pre-Code case law); Eljay, Jrs., Inc. v. Rahda Exports, 99 A.D.2d 408, 470 N.Y.S.2d 12 (App. Div. 1984) (since U.C.P. did not address fraud question, U.C.C. will apply). *See generally* J. DOLAN, THE LAW OF LETTERS OF CREDIT ¶ 4.05 (1984 & Supp. 1985) (arguing that courts should be free to apply the Code and its case law when not in direct conflict with the U.C.P.).

46. The U.C.C. and U.C.P. significantly conflict in only three respects: 1) The U.C.P. presumes a letter of credit is revocable; the U.C.C. is silent. *See infra* note 71. 2) The U.C.P. provides that an issuing bank has "reasonable" time to examine documents; the U.C.C. provides three banking days. 3) The U.C.P. provides that a letter of credit may be transferred only once; the U.C.C. has no limit.

Courts have also identified a fourth issue which, although not a direct conflict, nevertheless raises ambiguities. The U.C.C. permits an issuer to dishonor if there is "fraud in the transaction." *See infra* notes 136-142 and accompanying text. The U.C.P. does not expressly adopt or reject the rule, but certain sections arguably contradict the U.C.C. position. *Compare* Eljay, Jrs., Inc. v. Rahda Exports, 99 A.D.2d 408, 470 N.Y.S.2d 12 (App. Div. 1984) (U.C.P. does not govern fraud issue) *with* Shanghai Commercial Bank, Ltd. v. Bank of Boston Int'l, 53 A.D.2d 830, 385 N.Y.S.2d 548 (App. Div. 1976) (under U.C.P. fraud is not grounds for dishonor when documents conform "on their face").

For a more detailed comparison of the U.C.C. and U.C.P., see B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS, ¶¶ 8.1-.12 (rev. ed. 1981) and J. DOLAN, *supra* note 45, at ¶ 4.06[2].

47. This is consistent with the Code's principle that express terms shall prevail over custom and trade usage. MD. COM. LAW CODE ANN. § 1-205 (1975).

trade usage are major sources of interpretation.[48] A letter of credit governed by the U.C.P. is subject to special definitions and rules of construction to be applied in specified circumstances.[49] In addition, an international letter of credit may embody trade terms known as Incoterms—The International Chamber of Commerce's definitions of certain international commercial terms.[50] As noted earlier, the U.C.P. itself is used by courts as evidence of trade usage or custom.[51]

Notwithstanding special definitions or trade terms, interpretation of a letter of credit is governed primarily by two sources—the letter of credit itself and, if its meaning is not apparent from the face of the credit, parol evidence. In construing the text of a letter of credit, courts interpret ambiguous terms against the issuer. There are two policy reasons supporting this rule:[52] 1) The issuer drafted the letter of credit and generally the terms of a document are construed against its drafter; 2) The beneficiary must comply with the letter or credit and in most cases strict performance is required. Consequently, the burden of an ambiguous term should rest with the issuer.

Courts, however, have acknowledged that the general rules respecting interpretation of contracts should be tempered in the

48. *See* Venizelos, S.A. v. Chase Manhattan Bank, N.A., 425 F.2d 461 (2d Cir. 1970) (applying contract principles); MD. COM. LAW CODE ANN. § 1-205 (1975) (acknowledging importance of custom and trade usage in commercial agreements); *see also* Board of Trade v. Swiss Credit Bank, 597 F.2d 146 (9th Cir. 1979) (bank's evidence concerning usage of trade is admissible on the issue of the meaning intended by the parties). Although trade usage may be used to interpret the letter of credit, the issuer is not obligated to comply with a particular trade usage for the customer's benefit. Marino Indus. Corp. v. Chase Manhattan Bank, N.A., 686 F.2d 112, 119-20 (2d Cir. 1982); MD. COM. LAW CODE ANN. § 5-109(1)(c). Similarly, a beneficiary is not required to comply with banking practices not expressly required in the letter of credit. Bank of Canton, Ltd. v. Republic Nat'l Bank, 509 F. Supp. 1310 (S.D.N.Y.), *aff'd*, 636 F.2d 30 (2d Cir. 1980). Nevertheless, banks are required to observe general banking usage. MD. COM. LAW CODE ANN. § 5-109(1), (3) (1975).

49. U.C.P. arts. 22-55 (1983) contain suggested contents of various documents, procedures to be followed by issuers in the absence of the suggested contents, certain definitions, and suggested interpretations of ambiguous terms.

50. The International Chamber of Commerce (ICC) has published a dictionary of "Incoterms," ICC Publication No. 350. In addition, the ICC in Publication No. 373 has translated a number of English words respecting international commerce into German, Spanish, French, and Italian.

51. *See supra* text accompanying note 41.

52. For an excellent discussion of interpretation of letters of credit, see Rubenstein, *The Issuer's Rights and Obligations under a Letter of Credit*, 17 U.C.C. L.J. 129, 147-51 (1984).

context of letters of credit. First, a construction permitting enforcement is preferred over a construction that results in an unenforceable provision.[53] Second, the unique nature of a letter of credit and, in particular, the independence principle discussed below, dictate that courts are not to review the underlying contract between the beneficiary and customer to interpret a letter of credit.[54]

D. *The Independence Principle in Commercial and Standby Letters of Credit*

The key to all letters of credit and the essential reason they are so useful is that the issuer's obligations are independent of the underlying contract.[55] This is appropriately referred to as the "independence principle."[56] The traditional "commercial" letter of credit provides a payment mechanism [57] whereby a seller of goods, upon presentation of a draft or other specified documents, will receive payment directly from a bank or other source of credit. The issuer does not need to inquire into the underlying agreement; its obligation is to make payment upon presentation of complying documents.[58] Hence, the seller is assured of the purchase price from a secure source of credit, independent of any disagreements with the buyer.

Letters of credit are also used in situations where one party seeks to protect itself from another party's unsatisfactory performance or inability to perform. In this role, the letter of credit is referred to as a "guarantee" or "standby" letter of credit and is payable in the same manner as a commercial letter of credit, upon presentation of a draft or other specified documents.[59] For example, Seller may request Buyer to obtain a letter of credit to be drawn on should Buyer fail to make payment for goods delivered. Buyer's

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53. Venizelos, S.A. v. Chase Manhattan Bank, N.A., 425 F.2d 461, 465-66 (2d Cir. 1970); Data Gen. Corp. v. Citizens Nat'l Bank, 502 F. Supp. 776, 784 (D. Conn. 1980).

54. Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank, 571 F.2d 871, 874 (5th Cir. 1978).

55. MD. COM. LAW CODE ANN. § 5-114(1) (1975).

56. For a discussion of the independence principle, see B. CLARK, *supra* note 46, at ¶ 8.2[1].

57. For a discussion of the use of commercial letters of credit as *financing* mechanisms, see *infra* notes 151-173 and accompanying text.

58. As a matter of good banking practice, a bank's obligation under a letter of credit should not require the bank to determine issues of fact or law as between the customer and beneficiary. Comptroller of the Currency Interpretive Ruling, 12 C.F.R. § 7.7016(d) (1985).

59. *See* Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 394 (D. Md. 1982), *aff'd*, 704 F.2d 136 (4th Cir. 1983).

nonpayment triggers Seller's presentation to the issuer of a draft and documents certifying this default.[60]

Because a standby letter of credit is payable upon the default of a party to perform its obligation, this type of credit is in the nature of a loan from the issuer to the customer, and a guarantee from the issuer to the beneficiary.[61] It is, however, legally distinguishable from a guarantee and because of the independence principle, it actually offers the beneficiary more security than a guarantee.

In a typical guarantee, the guarantor is liable for the obligations of its principal—the guaranteed party[62]—and may itself raise most defenses available to its principal.[63] In a letter of credit transaction, the independence principle cuts off this opportunity of the issuer to use possible defenses of its customer.[64] The beneficiary is assured of prompt and certain payment if the documents are satisfactory. Thus, regardless of whether the letter of credit is a commercial or standby letter of credit the issuer is not obligated to (and should not) assess whether the underlying contract has been satisfactorily performed.

II. CHARACTERISTICS OF THE LETTER OF CREDIT

A. *Requirements*

Generally, the Uniform Commercial Code does not require any particular form or content for a letter of credit,[65] other than that it

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60. *Id.* at 388-89.

61. Ryan, *supra* note 14, at 405-06. The issuer here is in a significantly different posture since it is dealing with a customer who by definition is unable to perform its obligations under the underlying contract. Reimbursement protections in the agreement between issuer and customer are therefore extremely important to insure repayment of any amounts advanced. *Id.* at 412-15.

62. Crest Inv. Trust, Inc. v. Comstock, 23 Md. App. 280, 306, 327 A.2d 891, 906-07 (1974).

63. Ford Motor Credit Co. v. Lototsky, 549 F. Supp. 996, 998 (E.D. Pa. 1982); 10 S. WILLISTON, CONTRACTS § 1214 (3d ed. 1967).

64. See the discussions in American Nat'l Bank & Trust Co. v. Hamilton Indus. Int'l, Inc., 583 F. Supp. 164, 169-70 (N.D. Ill. 1984), *rev'd sub nom.* Banque Paribas v. Hamilton Indus. Int'l, Inc., 767 F.2d 380 (1st Cir. 1985), distinguishing a guarantee from a letter of credit. In the context of a standby credit the distinctions between a letter of credit and a guarantee are important since a letter of credit that resembles a guarantee is susceptible to an argument that it is ultra vires and unenforceable as against a bank issuer. Ryan, *supra* note 14, at 407,410. *See also* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F.2d 1285, 1286-87 (9th Cir. 1974) (instrument held to be a guarantee, but still enforceable as against bank); New Jersey Bank v. Palladino, 77 N.J. 33, 38-40, 46, 389 A.2d 454, 457-58, 461 (1978) (instrument construed as a letter of credit, not a guarantee).

65. *See, e.g.*, Data Gen. Corp. v. Citizens Nat'l Bank, 502 F. Supp. 776, 784 (D. Conn.

be in writing and signed by the issuer.[66] It does not even have to be labeled a letter of credit, unless it is a "clean" letter of credit,[67] in which case it must state its character either by caption or within the text.[68] Nor is consideration necessary to establish a letter of credit or a confirmation.[69] Consequently, the issuer cannot rely on a defense of failure of consideration as between itself and the customer in an attempt to avoid payment to the beneficiary.[70]

B. *Revocable vs. Irrevocable Letters of Credit*[71]

The issuer's ability to modify or revoke a letter of credit depends on whether the credit is revocable or irrevocable. Generally,

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1980); MD. COM. LAW CODE ANN. § 5-104(1) (1975). Nevertheless, the letter of credit is subject to applicable bank regulations, e.g., Comptroller of the Currency Interpretive Ruling, 12 C.F.R. § 7.7016 (1985) (specifying certain requirements to comply with good banking practices) and 12 C.F.R., §§ 32.1-.7 (1985) (lending limits). *See also* New Jersey Bank v. Palladino, 77 N.J. 33, 45, 389 A.2d 454, 460-61 (1978) (state banking act and banking regulations apply to letters of credit).

66. MD. COM. LAW CODE ANN. § 5-104(1) (1975). This requirement is satisfied by a telegram if it identifies the sender by an authorized authentication. *Id.* § 5-104(2). A confirmation must also be in writing and signed by the confirming bank.

67. A "clean" letter of credit does not require the presentation of any documents accompanying the draft or demand for payment. *See infra* notes 99-101 and accompanying text.

68. MD. COM. LAW CODE ANN. § 5-102(1)(c) (1975).

69. *Id.* § 5-105.

70. Barclays Bank, D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1239 n.22 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974) (lack of consideration no defense for confirming bank); Boise Cascade Corp. v. First Security Bank, 183 Mont. 378, 388, 600 P.2d 173, 179 (1979) (lack of consideration no defense for issuer).

Note that given the similarity between guarantees and standby letters of credit, counsel should consider whether a document is, in fact, a letter of credit rather than a guarantee when faced with an argument that the guarantee is unenforceable because of lack of consideration. American Nat'l Bank & Trust Co. v. Hamilton Indus. Int'l, Inc., 583 F. Supp. 164, 169 (N.D. Ill. 1984), *rev'd sub nom.* Banque Paribas v. Hamilton Indus. Int'l, Inc., 767 F.2d 380 (1st Cir. 1985) (guarantee actually a letter of credit, with payment upon notice of default equated to documentary demand).

71. Although most letters of credit are clearly identified as revocable or irrevocable, failure to label can lead to problems in interpretation. Article 5 of the U.C.C. is silent as to the status of a credit that does not state whether it is revocable or irrevocable. The drafters left this issue to be resolved by the courts in light of an established course of dealing, trade usage and the facts of the particular case. MD. COM. LAW CODE ANN. § 5-103 comment 1 (1975); West Va. Hous. Dev. Fund v. Sroka, 415 F. Supp 1107, 1111 (W.D. Pa. 1976). But note that in Article 2 sales agreements, any letter of credit will be deemed irrevocable unless otherwise agreed. MD. COM. LAW CODE ANN. § 2-325(3) (1975).

Courts interpreting Article 5 have also concluded that there is a presumption of irrevocability. Not only should silence be construed against the issuer, Data Gen. Corp. v. Citizens Nat'l Bank, 502 F. Supp. 776, 783-84 (D. Conn. 1984); Weyerhaeuser Co. v. First Nat'l Bank, 27 U.C.C. REP. SERV. (CALLAGHAN) 777, 781-82 (S.D. Iowa 1979), but

the issuer or confirming bank must sign a modification or a confirmation of a letter of credit regardless of whether the credit is revocable or irrevocable.[72] Thus, a modification between a customer and a beneficiary does not bind the issuer.[73] This rule provides significant protection to an issuer because an insolvent customer cannot waive requirements embodied in the letter of credit without the issuer's approval. On the other hand, the rule precludes an issuer from benefiting under a release executed by the customer and beneficiary unless the release expressly terminates the letter of credit. Because of the "independence principle," the issuer remains obligated, even though the underlying contract may no longer be valid.[74]

1. Revocable Letter of Credit.—Unless the parties agree otherwise, a revocable letter of credit may be modified or revoked by the issuer without notice or consent from the customer or beneficiary.[75] The ability to unilaterally modify or revoke is important because the issuer is likely to learn of the customer's insolvency or inability to perform well before the beneficiary has acted under the letter of credit.[76]

The beneficiary, however, is not completely without protection. First, the issuer cannot revoke the letter of credit after the beneficiary's delivery of the draft or demand for payment.[77] Second, the

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also, a presumption of irrevocability fosters certainty in letter of credit transactions and encourages their use.

Nevertheless, parties should be careful to state whether the letter of credit is revocable or irrevocable. Under U.C.P. art. 7(c), a credit is presumed to be *revocable*, and thus letters subject to the U.C.P. or a court relying upon it as evidence of custom or trade usage may conclude that a letter of credit is revocable. *See* Beathard v. Chicago Football Club, Inc., 419 F. Supp. 1133, 1138 (N.D. Ill. 1976).

72. MD. COM. LAW CODE ANN. § 5-104(1) (1975).

73. *See* AMF Head Sports Wear, Inc. v. Ray Scott's All-American Sports Club, Inc., 448 F. Supp. 222 (D. Ariz. 1978).

74. Housing Secs., Inc. v. Maine Nat'l Bank, 391 A.2d 311, 320 (Me. 1978) (release between customer and beneficiary does not terminate letter of credit absent beneficiary's consent).

75. MD. COM. LAW CODE ANN. § 5-106(3) (1975); Beathard v. Chicago Football Club, Inc., 419 F. Supp. at 1133, 1136 (N.D. Ill. 1976); West Va. Hous. Dev. Fund v. Sroka, 415 F. Supp. 1107, 1111 (W.D. Pa. 1976).

76. Note, however, that the U.C.C. requires the issuer to act in good faith. MD. COM. LAW CODE ANN. § 1-203 (1975).

77. Weyerhaeuser Co. v. First Nat'l Bank, 27 U.C.C. REP. SERV. (CALLAGHAN) 777, 782 (S.D. Iowa 1979). Nevertheless, if the issuer rejected the documents as defective, it presumably could then revoke before resubmission of complying documents.

The U.C.C. also protects a person authorized to honor or negotiate drafts under the terms of the original letter of credit, e.g., a negotiating bank. The negotiating bank is entitled to the issuer's honor of any draft negotiated before it received notice of the

authority to modify unilaterally is conditioned on any agreement between the parties—the standard exception found throughout the U.C.C.'s provisions. In addition to relying on express terms limiting the issuer, the beneficiary conceivably may also claim that a course of dealing between them constitutes a waiver of the unilateral right to modify.

2. *Irrevocable Letter of Credit.*—An issuer may have the ability to modify or revoke an *irrevocable* letter of credit, depending upon whether the credit has been "established." As regards the *customer*, a credit is established when it is *sent* either to the customer or to the beneficiary.[78] Since the issuer's act of sending controls the time of establishment, it is protected from continual modifications by the customer.[79] Once established, however, the irrevocable letter of credit can be modified or revoked as regards the customer only with the customer's consent.[80]

Generally, a letter of credit is effective with respect to the *beneficiary* when the beneficiary *receives* it or receives an authorized advice of its issuance.[81] The beneficiary's acceptance of the letter of credit is not required to render the issuer liable to the beneficiary.[82] In addition, a beneficiary's cause of action against the issuer for an improper modification or termination of the letter of credit does not arise until the beneficiary receives the letter of credit.[83] Until that time, the beneficiary has recourse for an improper or untimely letter of credit only against the customer on the basis of a breach of the underlying contract.[84]. Once an irrevocable letter of credit is established against the beneficiary, it may be modified or revoked only

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modification or revocation. MD. COM. LAW CODE ANN. § 5-106(4) (1975). Similarly, the issuer is entitled to reimbursement from its customer. *Id.* Thus, issuers are advised to notify all negotiating parties as soon as possible that a letter of credit is to be revoked.

78. MD. COM. LAW CODE ANN. § 5-106(1)(a) (1975). The sending of an authorized written advice of the letter of credit's issuance to the beneficiary also qualifies as "establishment" under this section.

79. Also, the risk of transmission is on the customer. *See id.* comment 1; § 5-107(4).

80. *Id.* § 5-106(2); Goodwin Bros. Leasing v. Citizens Bank, 587 F.2d 730, 733-34 (5th Cir. 1979).

81. MD. COM. LAW CODE ANN. § 5-106(1)(b) (1975).

82. Data Gen. Corp. v. Citizens Nat'l Bank, 502 F. Supp. 776, 782 (D. Conn. 1984).

83. MD. COM. LAW CODE ANN. § 5-106 comment 1 (1975).

84. The beneficiary presumably also has a cause of action against the issuer if the issuer agreed with the beneficiary under separate contract to provide the letter of credit.

with the beneficiary's consent.[85] A unilateral modification of an irrevocable letter of credit by the issuer constitutes a repudiation of the letter of credit, providing the beneficiary with the same rights as a seller after an anticipatory repudiation.[86]

The rules regarding modification of a letter of credit are deceptively simple. Although an issuer needs only the beneficiary's (and not the customer's) consent to modify the credit's terms as regards the beneficiary, the issuer may be precluded from obtaining reimbursement from the customer thereafter.[87] An issuer is particularly susceptible to this type of problem if it waives a condition in a letter of credit or amends it at the request of a beneficiary. At the time of waiver or amendment, the beneficiary's request may appear reasonable and of no consequence to the customer. Nevertheless, the customer may later refuse to reimburse, and the issuer cannot use this refusal as a valid defense to the beneficiary's claim for wrongful dishonor.[88] Consequently, an issuer should never amend a letter of credit without the consent of all parties.

The consent of the parties to an amendment need not be written[89] but must be explicit.[90] As a practical matter, however, the parties' written consent should be obtained to provide clear evidence in the event of a subsequent disagreement. Similarly, in the event the customer or beneficiary rejects a proposed amendment or modification, the rejecting party should provide a written rejection. A writing is advisable since a beneficiary or customer may be deemed to have acquiesced in a course of dealing and may be estopped from objecting to the modification.[91]

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85. MD. COM. LAW CODE ANN. § 5-106(2) (1975). The U.C.P. also requires the consent of the issuer and beneficiary. *See* U.C.P. art. 10(d) (1983). Presumably a modification respecting the customer requires the customer's consent to enable the issuer to collect reimbursement.

86. MD. COM. LAW CODE ANN. § 5-115(2) (1975); National Bank & Trust Co. v. J.L.M. Int'l, Inc., 421 F. Supp. 1269, 1272 (S.D.N.Y. 1976).

87. Chase Manhattan Bank v. Equibank, 550 F.2d 882, 886-87 (3d Cir. 1977).

88. *Id.*

89. City Nat'l Bank v. Westland Towers Apts., 107 Mich. App. 213, 221, 309 N.W.2d 209, 214 (1981), *rev'd on other grounds*, 413 Mich. 938, 320 N.W.2d 881 (1982).

90. *See* Asociacion De Azucareros v. United States Nat'l Bank, 423 F.2d 638, 641 (9th Cir. 1970); Banco Nacional v. Mellon Bank, N.A., 558 F. Supp. 1265, 1270 (W.D. Pa. 1983), *rev'd on other grounds*, 726 F.2d 87 (3d Cir. 1984). A possible defense for an issuer is that consent is not required if the issuer's statement was a new letter of credit instead of an amendment. *See Banco Nacional*, 726 F.2d at 92.

91. Lewis State Bank v. Advance Mortgage Corp., 362 So. 2d 406, 410 (Fla. Dist. Ct. App. 1978) (customer estopped).

C. *Termination*

In addition to revocation and modification, a letter of credit is also subject to termination based on an expiration date or on a maximum dollar amount specified in its text. The letter of credit should establish the terms and conditions of the termination without reference to the underlying agreement or any other factors that would require the issuer to look beyond the face of the instrument.[92]

Good banking practice requires that a letter of credit clearly identify a specified expiration date[93] and a maximum dollar amount payable under the letter of credit.[94] A beneficiary must be sensitive to the fact that courts generally insist on strict enforcement of expiration dates. The termination date must allow sufficient time to permit all documents to be completed, assembled, and transmitted to the issuer. In *Consolidated Aluminum Corporation v. Bank of Virginia*,[95] the Fourth Circuit adhered to a policy of strict enforcement of letter of credit terms by placing the risk of delay in the transmission of documents upon the beneficiary. The court held that the documents must be actually *received* by the issuer on or before the termination date.[96] A beneficiary has a significant interest in ensuring that the dollar amount is sufficient and clearly expressed, because in a documentary sale of goods the beneficiary will not be able to retain a security interest in any document of title presented to the issuer. An attempt by the beneficiary to retain a security interest in the documents will render the demand for payment noncomplying.[97]

Still another trap for the beneficiary arises when a second letter of credit is issued in lieu of extending the original one. Although the beneficiary may feel secure in obtaining the second letter of credit, unless there is an agreement expressly providing otherwise, the issuer may be required under this second letter to pay only obligations arising subsequent to its issuance. The beneficiary must draw under the first letter of credit before it expires to hold the issuer to all prior obligations.[98]

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92. *See, e.g.*, U.C.P. art. 46 (1983); 12 C.F.R. § 7.7016(b) (1985); Ryan, *supra* note 14, at 408-11.

93. Comptroller of the Currency Interpretive Ruling, 12 C.F.R. § 7.7016(b) (1985).

94. *Id.* § 7.7016(c).

95. 544 F. Supp. 386 (D. Md. 1982), *aff'd*, 704 F.2d 136 (4th Cir. 1983).

96. *Id.* at 395 (documents arrived four days late after nine days in the mail).

97. MD. COM. LAW CODE ANN. § 5-110(2) (1975).

98. *See* Easton Tire Co. v. Farmers & Merchants Bank, 642 S.W.2d 396, 399-400 (Mo. Ct. App. 1982).

D. *"Clean" vs. "Documentary" Letters of Credit*

Under a "clean" letter of credit the issuer pays the beneficiary upon presentation of the beneficiary's draft or demand for payment.[99] Since no other documents are required, the customer is provided little protection against an improper draw by the beneficiary. The latter can fail completely to perform the underlying contract, but absent fraud the issuer must pay and the customer must reimburse.[100] The customer's only recourse is to sue the beneficiary. A clean credit can also prove troublesome if the underlying contract is substantially modified. The customer may be liable under a valid letter of credit, with little or nothing left of the original contract.[101] Consequently, to protect themselves, the customer and issuer should condition the issuer's obligation under a letter of credit on presentation of certain documents evidencing satisfactory performance of the underlying contract as contemplated by the parties.

This "documentary" type of letter of credit requires the beneficiary to present specified documents and obliges the issuer to make payment only if these documents, on their face, comply with the terms prescribed in the letter of credit.[102] A true documentary credit must clearly identify the required documents and condition payment upon their presentation.[103] It should not only specify the contents of the documents, but ideally it should be issued with the forms of the documents attached.

The specific documents that should be required under the letter of credit will depend upon the particular transaction, but several guidelines can be suggested. The customer should require documents that, when received by the issuer, will assure the customer that the underlying contract has been satisfactorily performed by the beneficiary. The documents, however, must be identified in

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99. *See* United States v. Sun Bank, 609 F.2d 832 (5th Cir. 1980); Baker v. National Boulevard Bank, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975) (comparing clean and documentary letters of credit); *see also* Housing Secs., Inc. v. Maine Nat'l Bank, 391 A.2d 311, 319 (Me. 1978).

100. Sunset Invs., Ltd. v. Sargent, 52 N.C. App. 284, 288-91, 278 S.E.2d 558, 562-63, *cert. denied*, 303 N.C. 550, 218 S.E.2d 401 (1981). In the event of fraud, a court can enjoin payment under MD. COM. LAW CODE ANN. § 5-114(2)(b) (1975). *See infra* notes 136-142 and accompanying text.

101. Housing Secs., Inc. v. Maine Nat'l Bank, 391 A.2d 311, 319 (Me. 1978) (release between customer and beneficiary did not terminate letter of credit).

102. MD. COM. LAW CODE ANN. § 5-114(1) (1975).

103. United States v. Sun Bank, 609 F.2d at 832, 833 (5th Cir. 1980) (notwithstanding parties' intent, failure of letter of credit expressly to require presentation of documents results in "clean" letter of credit).

such a manner that the issuer will not be required to decide whether the beneficiary's performance was satisfactory.

If the beneficiary does not carefully review the documents required under the letter of credit, the customer can strip the beneficiary of the ability to control the documents and thereby of the ability to obtain payment independent from the customer's performance. For example, a requirement that the customer approve the documents presented to the issuer or that the customer provide a certificate of compliance can cause the beneficiary to be completely dependent upon the customer's "approval."[104]

The customer's concern with subjects such as quantity, model, color, and packaging can be confirmed in an invoice or packing list. The customer, issuer, and any party with a security interest in the goods should request documentation concerning insurance, method of shipment, and a bill of lading or other document of title. Documentary sales, however, may present problems in verifying subjective matters such as the quality or condition of particular goods. This difficulty can be overcome by a third party certificate stating that the goods are satisfactory or by a government certificate indicating the quality of the goods.

In the context of a standby letter of credit, the customer may want the issuer's obligation to be conditioned upon more than merely a statement by the beneficiary that a demand has been made or a default has occurred. For example, a letter of credit may require that the beneficiary obtain a certificate of a third party stating that certain events have occurred, or perhaps an opinion letter by counsel, satisfactory to the issuer, that payment is proper.

From the beneficiary's perspective the above documents should be prepared carefully to ensure prompt payment from the issuer. In addition, in the context of a commercial letter of credit, the beneficiary should make certain that all documents are either within its control or possession before parting with the goods. Otherwise, the transaction will be transformed into a standard credit sales exchange in which the beneficiary is dependent upon the customer's performance and payment.[105]

An unfortunate decision that considers the conditions on an issuer's payment under a letter of credit is *Raiffeisen-Zentralkasse Tirol v.*

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104. Similarly, if the customer is permitted to terminate the letter of credit at any time, the beneficiary is provided little, if any, security. *Cf.* Toyota Indus. Trucks U.S.A., Inc. v. Citizens Nat'l Bank, 611 F.2d 465 (3d Cir. 1979).

105. The beneficiary should also insure that the letter of credit's expiration date will permit the beneficiary to correct any deficiencies identified by the issuer.

First National Bank.[106] In *Raiffeisen*, the issuing bank refused to honor a letter of credit that on its face contained nondocumentary conditions[107] not met by the beneficiary. The reviewing court reasoned that a letter of credit transaction need not deal exclusively in documents, and that parties are free to include conditions requiring an issuer to assess the underlying performance.[108]

The *Raiffeisen* court's rationale, carried to its logical end, could create an exception that would swallow the independence principle.[109] If letters of credit are to maintain their commercial value, the issuer's obligation must be limited to determining documentary compliance only. Otherwise, provisions of the underlying agreement could be placed in the letter of credit, and under the *Raiffeisen* rationale, be used to demand performance to the satisfaction of the customer.[110]

E. *Documentary Compliance with the Terms of the Letter of Credit*

An issuer is obligated both to examine documents with care[111] and to honor drafts accompanied by complying documents.[112] Whether the goods or documents comply with the underlying contract is irrelevant. If the issuer accepts nonconforming documents or knowingly accepts fraudulent ones, it has breached its obligation to the customer. In the event of a wrongful honor, the issuer loses its right to reimbursement, including prepayments by the customer,

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106. 671 P.2d 1008 (Colo. Ct. App. 1983).

107. The relevant conditions were: " 'delivery . . . must be made no later than September 15, 1976,' and 'partial shipments not permitted.' " *Id.* at 1009. The letter of credit did not require documentation of either condition, both of which could have been easily accomplished.

108. *Id.* at 1009-1010.

109. Since the Code extends letter of credit status to a credit which does *not* require documents, but which "conspicuously states that it is a letter of credit . . ." MD. COM. LAW CODE ANN. § 5-102(1)(c) (1975), the argument is that nondocumentary conditions do not invalidate a letter of credit that is otherwise properly denominated.

The better view is that § 5-102(1)(c) contemplates the use of "clean" letters of credit and does not authorize the use of ersatz documentary credit letters containing nondocumentary conditions. *See id.* at official comment; Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F.2d 1285, 1286 (9th Cir. 1974); J. DOLAN, *supra* note 45, at ¶ 2.05.

110. Such a provision would arguably transform a letter of credit into a guarantee which under certain banking laws is unenforceable. *See supra* note 64.

111. MD. COM. LAW CODE ANN. § 5-109(2) (1975).

112. *Id.* § 5-114(1). However, in the event of fraud or forged documents the issuer is not required to make payment except to a holder in due course or similar party. *Id.* § 5-114(2)(a).

as well as its security interest in any collateral.[113]

The issuer is not required to make a quick decision. It may wait until the close of the third banking day following its receipt of the documents to honor a draft.[114] Unless the party presenting the documents expressly or impliedly consents to an extension of time, the issuer, by deferring honor beyond the prescribed time period, will dishonor demand.[115] Upon dishonor the issuer must return the draft and the documents to the presenting party.[116]

1. Strict Compliance.—Whether the documents presented to the issuer "comply" with the letter of credit has been the subject of extensive litigation. Most courts, including the Fourth Circuit, have held that the documents presented by the beneficiary must satisfy a standard of "strict compliance."[117] Any deviation from the specifications set forth in the letter of credit allows the issuer to dishonor its payment obligations.[118]

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113. *See* Transamerica Delaval, Inc. v. Citibank, N.A., 545 F. Supp. 200, 203 (S.D.N.Y. 1982).

114. MD. COM. LAW CODE ANN. § 5-112(1)(a) (1975). The U.C.P. allows "a reasonable time." U.C.P. § 16(c) (1983).

115. MD. COM. LAW CODE ANN. § 5-112(1) (1975).

116. The issuer's obligation is satisfied by holding the documents at the presenter's disposal and notifying him or her of this arrangement. *Id.* § (2).

117. *See, e.g.*, Board of Trade v. Swiss Credit Bank, 728 F.2d 1241, 1243 (9th Cir. 1984); Marino Indus. Corp. v. Chase Manhattan Bank, N.A., 686 F.2d 112, 134 (2d Cir. 1982); Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802, 805-06 (4th Cir. 1975); Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 395 (D. Md. 1982), *aff'd*, 704 F.2d 136 (4th Cir. 1983); Kelly-Springfield Tire Co. v. Dakota Northwestern Bank, N.A., 321 N.W.2d 516, 518-19 (N.D. 1982); Colorado Nat'l Bank v. Board of County Comm'rs, 634 P.2d 32, 40 (Colo. 1981).

In *Courtaulds*, the Fourth Circuit adopted the strict compliance standard. The letter of credit in that case required a commercial invoice stating it covered "100% Acrylic Yarn." The invoice presented by the beneficiary described the goods shipped as "Imported Acrylic Yarn." However, attached to the invoice were packing lists that stated "cartons marked: - 100% Acrylic." *Courtaulds*, 528 F.2d at 803. For this and other discrepancies, the issuer dishonored the beneficiary's presentment.

The court of appeals refused to accept the beneficiary's argument that the invoices satisfied the letter of credit requirements because of the attached packing lists. The *Courtaulds* court held that the issuer was required to look only at the invoice to determine compliance with the letter of credit and that it should not become embroiled in disputes between the buyer and seller. *Id.* at 805-06. The court also reasoned that the issuer had to require strict compliance because, otherwise, it would risk liability to its customer for unwarranted payment of the beneficiary's draft. *Id.* at 806.

118. *See, e.g.*, Eximetals Corp. v. Pinheiro Guimares, S.A., 51 N.Y.2d 865, 414 N.E.2d 399, 433 N.Y.S.2d 1019 (1980) (inspection certificate omitted phrase required by letter of credit and signatures were not properly appended).

Note, however, that although some courts may use the term "strict compliance," they permit reasonable exceptions so that the rule does not require a "mirror image" of

The principle of strict compliance, like the independence principle, ensures that an issuer will not be required to make a factual determination or look to the underlying contract to determine whether the parties' performance is satisfactory.[119] Since the issuer's role is basically a ministerial one and its obligations are defined within the four corners of the letter of credit, issuers are encouraged to participate in such transactions.[120] Likewise, beneficiaries are on notice as to exactly what is required for compliance. The net result is that certainty of payment is enhanced, which, in turn, supports the commercial viability of letters of credit.

Nevertheless, the strict compliance rule is subject to abuse. An issuer may rely on a technical inaccuracy in the documents to avoid payment. The issuer may wish to avoid payment to protect its customer[121] or to protect itself from an insolvent customer.[122]

2. *Reasonable Compliance.*—Based on a balancing of interests a few courts have adopted a second standard of compliance termed the "substantial performance" test.[123] Under this substantial or reasonable performance standard, as long as the documents conform to the material terms of the letter of credit the issuer must honor the documents.[124] The approach is flawed, however, since it requires the issuer to look at the underlying contract and exercise its discretion as to "materiality." This requirement is inconsistent with the issuer's strictly ministerial function and undercuts the certainty of

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the documents identified in the letter of credit. *See* Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank, 569 F.2d 699, 704 (1st Cir. 1978) (reference to "No. 18506" satisfies "NEMNB Credit No. 18506").

119. *Consolidated Aluminum*, 544 F. Supp. at 395-96.

120. *Id. See also* INA v. Heritage Bank, N.A., 595 F.2d 171, 176 (3d Cir. 1979).

121. *See, e.g.*, Kelly-Springfield Tire Co. v. Dakota Northwestern Bank, N.A., 321 N.W.2d 516, 518 n.4 (N.D. 1982) (bank acting on behalf of or at least influenced by customer).

122. *See* Colorado Nat'l Bank. v. Board of County Comm'rs, 634 P.2d 32, 34 (Colo. 1981) (customer insolvent). It is interesting to note that in Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802 (4th Cir. 1975) discussed *supra* note 117, the customer had declared bankruptcy. 528 F.2d at 804.

123. *See, e.g.*, Tosco Corp. v. FDIC, 723 F.2d 1242 (6th Cir. 1983) (applying Tenn. law); Crocker Commercial Serv. Inc. v. Countryside Bank, 538 F. Supp. 1360 (N.D. Ill. 1981); First Arlington Nat'l Bank v. Stathis, 90 Ill. App. 3d 802, 413 N.E.2d. 1288 (1980).

124. Crocker Commercial Serv. Inc. v. Countryside Bank, 538 F. Supp. 1360, 1362-63 (N.D. Ill. 1981). *See also* Colorado Nat'l Bank v. Board of County Comm'rs, 634 P.2d 32, 42 (Colo. 1981) (Lohr, J., concurring and dissenting) (discussing the substantial compliance test).

the transaction.[125]

Although the effects of a strict compliance standard are harsh and in certain situations inequitable, the beneficiary is in a position to negotiate the content of the required documents and presumably is aware of their technical requirements.[126] In addition, the beneficiary can negotiate certain provisions of the letter of credit, particularly the expiration and shipment dates, to provide ample opportunity to correct any problems in the documents which may be identified upon their presentation. Irrespective of any "built-in" protections, the beneficiary is advised to prepare the documents carefully and present them in a timely fashion to permit any errors to be corrected.[127]

3. *Waiver and Estoppel.*—The strict compliance rule is made more acceptable through the judicial development of waiver and estoppel theories.[128] Courts have recognized, perhaps in an unwritten attempt to temper the harshness of the rule, that the issuer may waive or be estopped from demanding strict compliance. An issuer may effect a waiver by expressly stating that a certain condition has been satisfied or by proposing an alternative method of performance.[129] In addition, an issuer who refuses to pay under a letter of credit upon specified grounds implicitly waives all other grounds of dishonor.[130]

To benefit from an implicit waiver, the beneficiary must have relied upon the issuer's statement and must have been in a position

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125. In Dolan, *Strict Compliance With Letters of Credit: Striking A Fair Balance*, 102 BANKING L.J. 18, 32 (1985), the author reaches a similar conclusion.

126. The beneficiary should "control" the documents either by actually preparing the documents (e.g., an invoice or packing list) or by controlling the documents prior to releasing the goods. If the beneficiary is accepting a document prepared by someone else, the underlying agreement should expressly condition the beneficiary's obligations to deliver goods upon receipt of the document in a reasonably satisfactory form. The appropriate parties should also agree to exercise their best efforts to remedy any deficiency in a document and acknowledge that time is of the essence.

127. *See, e.g.,* Kelly-Springfield Tire Co. v. Dakota Northwestern Bank, N.A., 321 N.W.2d 516, 518-19 (N.D. 1982) (beneficiary prepared invoices in wrong name).

128. See the discussion in Dolan, *supra* note 125, at 28-32 and cases cited therein.

129. Chase Manhattan Bank v. Equibank, 550 F.2d 882, 886 (3d Cir. 1977) (issuer may waive the restriction in letter of credit by choice or inadvertence); Beckman Cotton Co. v. First Nat'l Bank, 34 U.C.C. REP. SERV. (CALLAGHAN) 996 (N.D. Ga.), *aff'd,* 666 F.2d 181 (5th Cir. 1982) (bank officer extended expiration date).

130. *See, e.g.,* Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank, 569 F.2d 699, 703-04 (1st Cir. 1978) (statement of additional grounds for dishonor made *after* time for remedial action was subject to waiver); Barclays Bank, D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224 (5th Cir. 1973), *cert. dismissed,* 414 U.S. 1139 (1974) (issuer's failure to identify and notify presenter of error in documents constitutes waiver).

to rectify any defects identified by the issuer. Consequently, the implicit waiver theory is inapplicable when the issuer is not required to respond to the beneficiary before the letter of credit expires or when the defect is incurable.[131]

The waiver theory also may be inapplicable when the beneficiary knowingly tenders nonconforming documents.[132] This exception, however, should be invoked only in the most egregious circumstances since it is susceptible to abuse. Conceivably, every time an issuer dishonors, it could claim that the beneficiary is knowingly presenting a nonconforming document. As a result, the issuer would not be required to identify the reasons for dishonoring the documents.[133]

In addition, an estoppel theory may preclude an issuer from dishonoring when the issuer has acquiesed in the past to defects in documents.[134] Estoppel is not available to a beneficiary, however, if the issuer had obtained the customer's consent when acquiesing to such defects in past transactions.[135]

F. Fraud

Although the draft and documents presented to the issuer may on their face appear to comply with the letter of credit, an issuer is not obligated to pay if:

1. A document does not conform to warranties made under negotiation or transfer of a document of title or security;
2. A document is forged;
3. A document is fraudulent; or
4. There was "fraud in the transaction."[136]

In these four circumstances, if the presenter is not a party with

131. *See* Crocker Commercial Serv. Inc. v. Countryside Bank, 538 F. Supp. 1360, 1363-64 (N.D. Ill. 1981); Colorado Nat'l Bank v. Board of County Comm'rs, 634 P.2d 32, 41 (Colo. 1981). *But see* Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, N.A., 707 F.2d 680, 684-85 (2d Cir. 1983) ("Whether or not a defect can be cured is irrelevant . . ." in context of waiver).

132. Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 238-39 (5th Cir. 1983) (when beneficiary knows or should know that documents are defective, issuer not obligated to identify defects).

133. *Id.* at 240-42 (Goldberg, J., dissenting).

134. Crocker Commercial Serv. Inc. v. Countryside Bank, 538 F. Supp. 1360, 1363-64 (N.D. Ill 1981.); U.S. Indus., Inc. v. Second New Haven Bank, 462 F. Supp. 662, 665-66 (D. Conn 1978).

135. Courtlands N. Am. Inc. v. North Carolina Nat'l Bank, 528 F.2d 802, 807 (4th Cir. 1975) (issuer's past actions do not estop future rejection since issuer obtained customer's consent).

136. MD. COM. LAW CODE ANN. § 5-114(2) (1975).

holder in due course status,[137] the issuer *may* but is not required to pay the beneficiary.[138] In exercising this discretion the issuer must act in good faith, but it is not obliged to heed the request of its customer to dishonor for fraud or forgery when the documents appear regular on their face.[139] Should the issuer decide not to honor the documents, it runs the risk, of course, that the presenting party will bring a suit for wrongful dishonor. Consequently, an issuer should provide for adequate indemnification in its agreement with the customer.[140]

The inclusion of "fraud in the transaction" on the list of irregularities raises the question whether the drafters intended that issuers should analyze the underlying transaction. Because "fraudulent" documents are separately named, one could argue that "fraud in the transaction" must include circumstances beyond the presentation of documents.[141] The counterargument is that such a construction violates the independence principle and consequently diminishes the reliability and efficiency of letters of credit.[142] The better view is that a showing of fraud permitting an issuer to dishonor or a court to enjoin honor should involve the documents only.

The language of section 5-114 has also presented courts with the questions of whether the standard for issuing an injunction is different in the letter of credit context[143] and whether a mere breach of warranty in the underlying contract constitutes fraud.[144] Both should be answered in the negative. A more "generous" injunction standard would serve to undercut the reliability of letters of credit and their commercial vitality. Therefore, courts should insist on the recognized elements of injunctive relief[145] in addition to the claim of fraud or forgery. As to whether a breach of warranty constitutes

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137. An issuer *must* honor the demand for payment from such a presenter. *Id.* § 5-114(2)(a).

138. *Id.* § 5-114(2)(b).

139. *Id.*

140. The customer can always attempt to obtain an injunction prohibiting the issuer from making payment. A court of appropriate jurisdiction may enjoin honor when there is fraud or forgery in the documents. *Id.*

141. *See* Comment, *Article 5: Letters of Credit*, 18 WAKE FOREST L.REV. 317, 330-34 (1982).

142. *See, e.g.*, Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 605-06 (1978); Thorup, *Injunctions Against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves?*, 101 BANKING L.J. 6, 15-16 (1984).

143. Thorup, *supra* note 142, at 17-19.

144. Comment, *supra* note 141, at 335-37.

145. A customer in seeking an injunction should be made to prove irreparable injury, inadequate legal remedy, and a likelihood of success on the merits.

fraud, the independence principle dictates that payment under a letter of credit should not be withheld unless the breach amounts to gross or egregious fraud. Thus, although the goods delivered may not conform to the underlying contract, a party should not be permitted to obtain an injunction against payment.

G. *Standard to Determine Wrongful Payment*

Although the "strict compliance" rule is advisable in assessing whether the beneficiary has satisfied the terms of the letter of credit, courts have recognized that the lesser "reasonable performance" standard is appropriate in determining an issuer's liability in wrongful payment situations, i.e., when the customer complains that the issuer should *not* have made payment.[146] Generally, the issuer is obliged to examine the documents with care to determine whether, on their face, they "appear to comply with the terms of the credit."[147] Customers have pressed for the strict compliance standard, claiming that an issuer's acceptance of documents that do not strictly comply with the letter of credit constitutes wrongful payment.

Courts have wisely rejected this argument, recognizing that the customer's relationship with the issuer is significantly different from the issuer's relationship with the beneficiary.[148] Giving the issuer the benefit of a strict compliance standard limits its entanglement with the underlying contract and generally encourages it to undertake letter of credit transactions. The issuer's obligation to the customer, on the other hand, should be defined by the terms of its agreement with the customer rather than the letter of credit. If the customer fails to specify the required contents of documents, the customer then should not be permitted to hold the issuer liable for strict compliance with terms selected by the issuer. The ambiguous requirements that the customer provided should be resolved against the customer.[149]

To avoid problems of wrongful payment, the customer should carefully specify the contents of the documents to be presented, and

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146. Transamerica Delavel, Inc. v. Citibank, N.A., 545 F. Supp. 200, 203-04 (S.D.N.Y. 1982); Far Eastern Textile, Ltd. v. City Nat'l Bank & Trust Co., 430 F. Supp. 193, 196 (S.D. Ohio 1977) (dictum).

147. MD. COM. LAW CODE ANN. § 5-109(2) (1975).

148. Transamerica Delaval Inc. v. Citibank, N.A, 545 F. Supp. 200, 203-04 (S.D.N.Y 1982).

149. *Id.*

ideally, should provide the issuer with the required form of documents. The issuer, then, must accurately incorporate the description of the required documents in the letter of credit or attach the form selected by the customer. As an added precaution, especially in jurisdictions where the "reasonable" standard for wrongful honor has not yet been articulated, the issuer should provide in its agreement with the customer that it need only accept documents that reasonably satisfy the requirements specified by the customer.[150]

H. The Letter of Credit as a Financing Tool

An attractive feature of a letter of credit is that the beneficiary may use it to finance operations. A supplier may desire some protection to engage in a transaction with the beneficiary. The supplier could obtain a security interest in the beneficiary's contract right with the customer, but the supplier would then be relying on the customer's performance. A letter of credit, however, provides the supplier additional protections because the supplier need not rely upon the customer's credit and may even be protected against a cancellation of the order.[151] The beneficiary can use the letter of credit as a financing tool in three ways:

i) To transfer or assign the letter of credit;

ii) To assign the right to the proceeds of the letter of credit; or

iii) To use the letter of credit as collateral to obtain a second letter of credit for the benefit of the supplier.

1. Transfer of a Letter of Credit.—Generally a letter of credit can be transferred or assigned only when it expressly states that it is transferable or assignable.[152] This strict rule is justified because the customer's only assurance of satisfactory performance under a letter

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150. *See* B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 8.11[3] (Supp. 1985). The issuer may also provide in the agreement that documents in certain circumstances (e.g., certificate of a government in politically unstable condition) may be accepted as presented. *See* MD. COM. LAW CODE ANN. § 5-109 comment 2 (1975). The agreement will be enforceable provided it is not contrary to MD. COM. LAW CODE ANN. § 1-102(3) (1975) (agreements as to standards of performance will be controlling provided they are not manifestly unreasonable).

151. MD. COM. LAW CODE ANN. § 5-116 comment 1 (1975 & Supp. 1985).

152. *Id.* § 5-116(1). *See* Shaffer v. Brooklyn Park Garden Apts., 311 Minn. 452, 458-59, 250 N.W.2d 172, 177 (1977).

of credit is the documents tendered to the issuer.[153] Thus, a transfer or assignment of the letter of credit will substitute the performance of another party and may deprive the customer of an essential aspect of the transaction. Although an issuer could consent to a transfer or assignment without the approval of its customer, the issuer would jeopardize its right to reimbursement.

Notwithstanding the significant policy reasons justifying restrictions upon the transfer or assignment of a letter of credit, section 5-116 has been construed to preclude only voluntary transfers and not transfers by operation of law.[154] Nevertheless, transfers by operation of law should be permitted only when the underlying contract has been substantially performed by the original beneficiary.[155] This limited exception does not significantly prejudice the customer because the customer is obtaining the agreed-upon performance. The exception is problematic since it requires the issuer to make a factual determination concerning performance of the underlying contract; thus courts should limit the exception to the facts of each case.

The U.C.C.'s only reference to the rights of a transferee is a provision in the official comment stating that 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."[156] The transferee of a letter of credit has the same rights as an original beneficiary respecting the issuer's obligations to honor the draft within three banking days and to return the draft upon dishonor, as well as respecting the issuer's liability for nonpayment.[157] Similarly, the transferee undertakes the obligations of an original beneficiary including the warranty upon demand for payment that the necessary

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153. MD. COM. LAW CODE ANN. § 5-116 comment 1 (1975 & Supp. 1985). *See* B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 8.12 (1981 & Supp. 1985).

154. *See, e.g.*, American Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420, 423-24 (S.D.N.Y. 1979) (doctrine of state succession permits new government to succeed to rights of prior government); Pastor v. National Republic Bank, 76 Ill.2d 139, 149-50, 390 N.E.2d 894, 898 (1979) (statutory successor entitled to draw under standby letter of credit). *But see In re* Swift Aire Lines, Inc., 30 Bankr. 490, 495-96 (Bankr. 9th Cir. 1983) (trustee of beneficiary in bankruptcy unable to assume letter of credit).

155. In Pastor v. National Republic Bank, 76 Ill. 2d 139, 390 N.E.2d 894 (1979), the court noted that its holding was based upon the original beneficiary's full performance of its obligations to the customer. *Id.* at 151, 390 N.E.2d at 898-99.

156. MD. COM. LAW CODE ANN. § 5-116 comment 2 (1975 & Supp. 1985).

157. National Bank & Trust Co. of N. Am., Ltd. v. J.L.M. Int'l, Inc., 421 F. Supp. 1269 (S.D.N.Y. 1976) (transferee acquires cause of action held by beneficiary).

conditions of the letter of credit have been satisfied. Since the letter of credit is not a negotiable instrument, the transferee is *not* a holder in due course[158] and may be liable for defenses that the issuer has against the assignor.

The position of a transferee of a letter of credit contrasts with that of a holder of a negotiated draft for payment. The holder of the negotiated draft can draw under the letter of credit and may qualify as a holder in due course. Thus, in certain circumstances, it is advantageous for a party to take a negotiable draft rather than the letter of credit, since as a holder in due course the party would be protected against claims of forged or fraudulent documents and fraud in the transaction.[159] However, because the holder of a negotiated draft is often a business associate or acquaintance of the beneficiary, there is a greater possibility that the holder has knowledge of defenses prior to taking the instrument and may not qualify as a holder in due course.[160]

The U.C.P. provides that a credit is transferable only if it has been expressly so designated.[161] Even then it can be transferred only once,[162] and generally in the manner specified in the original credit.[163]

2. *Assignment of Proceeds.*—A second way in which a beneficiary can use a letter of credit as a financing tool is to assign the *proceeds* of the letter of credit to the supplier. The U.C.C. permits an assignment of proceeds even though the credit states that the letter itself is nonassignable.[164] An assignment of proceeds is treated as an assignment of an account under Article 9.[165] Article 5, however, acknowledging the unique nature of a letter of credit, specifies certain requirements.

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158. Shaffer v. Brooklyn Park Garden Apts., 311 Minn. 452, 458-59, 250 N.W.2d. 172, 177 (1977).

159. MD. COM. LAW CODE ANN. § 5-114(2) (1975).

160. Shaffer v. Brooklyn Park Garden Apts., 311 Minn. 452, 459-61, 250 N.W.2d. 172, 177-78 (1977).

161. U.C.P. art. 54(b) (1983).

162. *Id.* at art. 54(e). An exception is made for the separate transfers of fractions of the letter of credit, provided the aggregate transfers do not exceed the total amount of the credit. *Id.*

163. Note, however, that to accommodate a beneficiary transferring a letter of credit to a supplier, the U.C.P. permits modification of the original credit with respect to certain enumerated areas. *Id.*

164. MD. COM. LAW CODE ANN. § 5-116(2) (1975 & Supp. 1985). *See* GATX Leasing Corp. v. DBM Drilling Corp., 657 S.W.2d. 178, 183 (Tex. Civ. App. 1983).

165. MD. COM. LAW CODE ANN. § 5-116(2) (1975 & Supp. 1985).

Section 5-116(2)(a) provides that an assignment is not effective until the letter of credit or the advice of the letter of credit is delivered to the assignee. Delivery of the document also perfects the assignee's security interest.[166] Because drafts or demands for payment are used to obtain payment under a letter of credit, the U.C.C. defines the issuer's obligation to honor the demands. An issuer is entitled to honor drafts or demands by the beneficiary until it receives notification of the assignment that: (1) is signed by the beneficiary; (2) reasonably identifies the letter of credit; and (3) requests that payments be made to the assignee.[167] Even after receiving this notice the issuer may refuse to make payment unless the assignee actually exhibits the letter of credit.[168]

3. Back-to-Back Letter of Credit.—The assignee of the proceeds under a letter of credit is in a better position than if it had a security interest in the proceeds, but it is best protected with a back-to-back letter of credit. In this type of transaction the beneficiary uses the customer's letter of credit as collateral to obtain a new, second letter of credit for the benefit of the supplier.[169]

From the supplier's point of view, the back-to-back letter of credit is preferable to an assignment of proceeds because, as the beneficiary of the second letter of credit, the supplier is able to perform and receive payment independent of any defenses, amendments, or other limitations contained in the primary letter of credit.[170] An assignee of proceeds, on the other hand, is dependent on the performance of the original beneficiary and may not make an independent presentment to the issuer.[171]

The issuer of the second letter of credit can protect itself by obtaining a security interest in any collateral, including a document of title or account of the beneficiary, as well as an interest in the proceeds of the original letter of credit.[172] The issuer of the second letter of credit may also attempt to limit its liability by requiring the

166. *Id.* § 5-116(2)(a).

167. *Id.* § 5-116(2)(b).

168. *Id.* § 5-116(2)(c).

169. *See* Decker Steel Co. v. Exchange Nat'l Bank, 330 F.2d 82, 86-87 (7th Cir. 1964).

170. Note that an assignee of proceeds is subject to amendments to the letter of credit, the defense of fraud, and any right of set off the issuer may have as an account party under Article 9. *See* Board of Trade v. Swiss Credit Bank, 728 F.2d 1241, 1244 (9th Cir. 1984).

171. Shaffer v. Brooklyn Park Garden Apts., 311 Minn. 452, 458-59, 250 N.W.2d. 172, 177 (1977).

172. To insure the issuer's ability to obtain an interest in the original letter of credit, the drafters of Article 5 purposely made the ability to assign *proceeds* of the letter of

same documents as required in the original letter of credit. Nevertheless, unless the issuers are the same, the second issuer runs the risk of inadvertently accepting documents containing technical errors that will permit the first issuer to dishonor the demand for payment.[173]

III. ADVANTAGES OF THE LETTER OF CREDIT

The letter of credit is a useful tool that can facilitate a commercial transaction by providing either a payment or financing mechanism or by guaranteeing satisfactory performance. Practitioners are encouraged to make imaginative use of them to make an otherwise impossible transaction a reality.[174]

As noted in the discussion above, the primary advantage of a letter of credit is its substitution of the issuer's credit for the customer's credit. As a result, the beneficiary need not concern itself with the customer's solvency, relying instead upon the credit of a known and reputable entity—most often a bank. Although the beneficiary could itself evaluate a customer's credit, most issuers of letters of credit are in the business of assessing credit and can perform the task more efficiently and economically. Another significant advantage is that the beneficiary avoids the risk of the customer's bankruptcy. A letter of credit can also assist parties in avoiding currency or import restrictions, as well as in controlling the risk of fluctuating currency rates.[175]

In a sale of goods context, the seller/beneficiary can use the letter of credit as collateral to finance production. Once the goods

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credit independent of the beneficiary's ability to transfer the letter of credit itself. MD. COM. LAW CODE ANN. § 5-116 comment 3 (1975 & Supp. 1985).

173. For some illustrative back-to-back transactions, see Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 605-07 (1979).

174. For example, letters of credit can be used: to support the return of leased merchandise, Tranarg, C.A. v. Banca Commerciale Italiana, 90 Misc. 2d 829, 396 N.Y.S.2d 761 (Sup. Ct. 1977); as a standby deposit to guarantee consummation of a loan, Fidelity Bank v. Lutheran Mutual Life Ins. Co., 465 F.2d 211 (10th Cir. 1972); as collateral security for a construction loan, O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 250 S.E.2d 587 (1978); to guarantee payment under a rental contract, Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316 (1975); to protect the surety on an appeal bond, INA v. Heritage Bank, N.A., 595 F.2d 171 (3d Cir. 1979); and to assure a seller's proper delivery of goods, Dynamics Corp. of Am. v. Citizens & Southern Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973). For a more detailed discussion of possible uses, see J. Dolan, *supra* note 45, at ¶ 1.06.

175. For a more detailed discussion of these features, see Comment, *Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions*, 4 CUM.-SAM. L. REV. 134, 146-47 (1973).

are shipped, the seller is assured prompt payment upon presentation of complying documents. Consequently, the seller avoids delays incurred in billing and collection of the purchase price. The buyer/customer, on the other hand, avoids prepaying the entire amount of the purchase prior to its shipment without any assurance of satisfactory performance. Because the letter of credit mechanism permits the buyer to specify that certain documents accompany the draft for payment, the buyer can be reasonably assured that complying documents will signify adequate performance.

In a standby letter of credit, the beneficiary knows that a creditworthy party will pay upon presentment of documents that substantiate the claim of default or nonperformance. The customer or "guaranteed" party benefits by not having to escrow the funds or otherwise restrict the use of funds.

The independence principle, which insulates the letter of credit transaction from the underlying contract, assures that payment to the beneficiary is not subject to the buyer's remorse or claims that the goods are not satisfactory. The buyer is not able to withhold the purchase price for the purpose of bargaining power, but must sue the seller to recover the payment already made by the issuer. This situation is the opposite of the more familiar breach of contract posture in which the seller is forced to sue the buyer for nonpayment when the latter is dissatisfied with the goods.

A letter of credit is a flexible instrument that permits the parties to negotiate various protections. The customer, for example, may negotiate the terms of the underlying contract to require that the letter of credit provide for only a certain percentage of the purchase price, thereby permitting the customer to "hold back" a part of the price in the event of unsatisfactory performance. The customer can also require that payment be conditioned on the beneficiary's presentation of a certificate acknowledging the satisfactory inspection of the goods either by the customer or by an independent third party. The customer may also negotiate the time within which the issuer must pay the beneficiary to allow time to obtain an injunction prohibiting improper payment. Finally, the buyer/customer can require the seller/beneficiary to obtain a standby letter of credit to secure the seller's satisfactory performance.[176]

Notwithstanding its benefits, the letter of credit has significant limitations that should be acknowledged by both parties. Foremost,

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176. *See* J. Dolan, *supra* note 45, at ¶ 3.07(5); Saunders, *Letters of Credit in International Transactions*, 102 BANKING L.J. 361, 365-67 (1985).

all parties should recognize that payment is conditioned on satisfactory presentation of documents, regardless of the performance of the underlying contract. In the event of the beneficiary's unsatisfactory performance, the customer's options are limited essentially to: (1) an action against the issuer on the basis of wrongful honor if the issuer accepted documents that were not satisfactory; (2) an action against the beneficiary for fraud or breach of the underlying contract; and (3) an injunction against payment, or at least a request that the bank not pay if there are forged or fraudulent documents or there is fraud in the transaction.

The beneficiary should acknowledge the risk that despite satisfactory performance of the underlying contract, a failure to present complying documents timely will entitle the issuer to dishonor. As a result, the beneficiary's options are to: (1) sue the issuer for wrongful dishonor of the documents; or (2) seek payment from the customer under the underlying contract.

On balance, however, the letter of credit's advantages clearly outweigh its disadvantages. Its enormous utility as a payment, financing, and guarantee mechanism should convince practitioners to investigate its possibilities. Careful drafting and an appreciation not only of the parties' respective interests, but also of the letter of credit mechanism itself, should both minimize risks and suggest creative uses.