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Letters of Credit: Iranian Cases and the Need to Adapt Letters of Credit to Their Proposed Uses

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LETTERS OF CREDIT: IRANIAN CASES AND THE NEED TO ADAPT LETTERS OF CREDIT TO THEIR PROPOSED USES

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INTRODUCTION

In the last thirty years, the use of standby letters of credit¹ in contracts between corporations in industrialized nations and governments in Third World countries has increased significantly. One of its most common new uses is as a guarantee by the seller that he will fully perform his obligations under the contract. There have also been many other uses developed for standby letters of credit in other business transactions.² Standby letters of credit are different in both function and form from traditional letters of credit which are used to facilitate payment for goods in international transactions.³ Yet, despite the dramatic differences between traditional letters of credit and standby letters of credit, both the banks and the courts view them as identical financial instruments. Due to the difficulty of adaptating the new uses of letters of credit to the applicable laws, greater risks have been created for all the parties to a letter of credit contract. As a result, the entire letter of credit system has been recently threatened by the unusual, though not necessarily uncommon, political situation in Iran which triggered numerous standby letter of credit disputes.⁴ The cessation of commercial relations between industrialized nations and

¹ The Comptroller of the Currency has defined the standby letter of credit as follows:

A "standby letter of credit" is any letter of credit or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed or advanced for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make any payment on account of any default by the account party in the performance of an obligation. 12 C.F.R. § 7, 1160(a) (1979). The Federal Deposit Insurance Corp. ("FDIC") have similarly defined standbys. 12 C.F.R. 337.2(a) (1979); *See also* Board of Governors of the Federal Reserve System in Regulation H, 12 C.F.R. § 208(d) (1979).

² "Standby credits have been used in connection with construction projects both to secure the payment of commitment fees to permanent lenders, and to secure interim lenders against the developers' failure to obtain permanent financing. They have likewise been used as performance bonds seeking developers' obligations to municipal government, as substitutes for working capital deposits by developers in connection with H.U.D. — insured mortgages, as security for payment of notes given by purchasers of real estate, and as security for the insurance of security bonds in connection with various incidents of the litigation process. They have also been utilized, with great frequency and success, to support the insurance of commercial paper by corporate borrowers." Weisz and Blackman, *Standby Letters of Credit After Iran: Remedies of the Account Party*. 1982 U. ILL. L. REV. 355, 359. The two most common uses of standby letters of credit in international transactions have been as good performance guarantees and advance payment standbys. *See* notes 13-22 and accompanying text.

³ A traditional letter of credit is secured by a buyer from a bank in the amount of the purchase price for the benefit of a seller so that neither party will have both the goods and the money at the same time. *See* notes 6-12 and accompanying text.

⁴ To condemn the imperialistic tendencies of industrialized nations acting in concert with an overthrown government is a natural, often mandated action for a new government to take to stop the alleged oppression of its people. Unfortunately, the new government must often condemn the innocent along with the not so innocent parties, either because the new government cannot tell the difference, or because its people could not be expected to tell the difference. In Iran, this militant hatred for everything American was opposed only by the moderate voice of Sadeq Ghotbzadeh. As a result, he fell from power and was executed as a traitor.

governments in Third World countries sparks efforts to enjoin payments of standby letters of credit, either because demands for their payment might be fraudulent, or because large payments are still owed by the party demanding payment under the standby letters of credit.

This article will discuss the basic functional differences between traditional letters of credit and standby letters of credit. The discussion will focus on the difficulties faced by courts when they have applied the usual rules of judicial review, originally developed for traditional letters of credit, to standby letters of credit. Part I will discuss the basic differences between standby and traditional letters of credit. Part II will discuss the main issues involved in letter of credit disputes: nonconformity of documentary demands, fraud in the transaction, indispensable parties, and letter of credit disputes versus disputes on the contract. Part III will discuss *Itek Corporation v. First National Bank of Boston and Bank Melli Iran*.⁵ This is the only case in which a permanent injunction was issued by a federal district court enjoining an American bank from honoring a demand by the Iranian bank for payments allegedly made in conformance with certain standby letters of credit. The discussion will cover force majeure clauses, non-conformity of documents presented, fraud in the transaction under UCC § 5-114, and the Iranian bank as a government entity. Part IV will recommend the restructuring of letters of credit so that the requirements will reflect both the use to which the letter of credit will be put and will bring all types of letters of credit in line with the applicable laws.

I. DIFFERENCES BETWEEN TRADITIONAL AND STANDBY LETTERS OF CREDIT

A. *Traditional Letters of Credit*

The traditional letter of credit has become an invaluable tool in international transactions. It is also known as a commercial or documentary letter of credit.⁶ The traditional letter of credit is used in international business transactions for goods in which the seller and the buyer are separated by long distances, have different legal systems, and do not trust each other. Letters of credit avoid placing either party in the position of controlling both the goods and the money at the same time.⁷ To avoid this problem, the contracting parties agree to involve a third party: preferably a large, stable, and internationally known bank with branches in the countries of both buyer and seller. In this ideal situation, the buyer procures a letter of credit in favor of the seller from the bank. Once informed of the transaction between the buyer and the bank, the seller has the added comfort of the good credit standing of the bank as opposed to the unknown credit standing of the buyer. The letter of credit is usually irrevocable⁸ and the creditworthiness of the buyer is now

⁵ No. 80-58 Slip Opinion (D. Mass., May 25, 1982), No. 83-1632 Slip Opinion (1st Cir. March 29, 1983).

⁶ A traditional letter of credit is perhaps best described as a documentary letter of credit. However, because some standby letters of credit are also documentary, for the purposes of this article, the two types will be referred to as traditional and standby letters of credit.

⁷ Note, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L L.J. 189, 191 (1980), Note, *The Role of Standby Letters of Credit in International Commerce: Reflections After Iran*, 20 VA. J. INT'L. L. 459, 461 (1980).

⁸ The UNIFORM COMMERCIAL CODE [hereinafter cited as UCC] leaves open the question of whether an unmarked letter of credit is irrevocable or revocable, thus allowing courts to determine revocability based on custom and usage. UCC § 5-103 Comment 1 (1977). The UNIFORM CUSTOMS

the bank's concern, not the seller's. At this point the seller may not simply demand payment from the bank: he must produce a series of documents previously agreed upon by the buyer and himself. The particular documents are stipulated in the agreement between the buyer and the bank. They usually show that the goods, such as wheat, have been shipped in the proper amount, at the proper time, and are of the proper quality. Once the seller has these documents, he must present them to the bank. If the bank decides that the documents conform to the agreement between the seller and bank, as agreed upon by the buyer and the seller, the bank will honor the seller's demand for payment.⁹ The transaction is then complete.

The legal problems which arise in the above transaction occur because of poor drafting of the underlying contract, the use of documents in the credit transaction which fail to protect the buyer, dishonesty on the part of the seller who ships inferior or different goods, or dishonesty on the part of a seller who presents fraudulent documents to the bank for payment. Even if the buyer has told the bank that the seller has breached the underlying contract, when the documents conform on their face to the letter of credit agreement, the bank must honor the demand for payment, unless the buyer can show that the seller has perpetrated a fraud in the transaction.¹⁰ The legal premise is that letters of credit are totally independent of the underlying contract.¹¹ In the absence of fraud in the transaction, which is the lone exception, banks will honor a conforming demand for payment in the interest of protecting their own reputation.¹² This leaves any dispute over aspects of the underlying contract to be settled between the contracting parties.

B. *Standby Letters of Credit*

As can be inferred from the traditional letter of credit situation outlined above, all aspects of the transaction are tangible: the goods, the letters of credit, and the documents — all of which maintain the desirable balance in international transactions. Standby letters of credit are used when the contract obligations become more complicated and the parties still wish to maintain a balance of interests. Standby letters are not only used before complete performance has occurred, but afterwards, as a warranty that the goods will perform as promised by the seller. Standby letters of credit can also be issued in favor of the buyer equal to the amount of the down payment on the contract price to guard against a complete default by the seller.¹³ The basic problem with, and the main advantage of, standby letters of credit is the variety of uses to which this low-cost security mechanism can be put.

AND PRACTICES FOR DOCUMENTARY CREDITS in Article 1(c) specifies that if a letter of credit is not marked irrevocable then it is presumed to be revocable. International Chambers of Commerce, UNIFORM CUSTOMS AND PRACTICES FOR DOCUMENTARY CREDITS, Brochure 222, Art. 1(c) (rev. ed. 1962) [hereinafter cited as UCP].

⁹ UCC § 5-109, *supra* note 8.

¹⁰ UCC § 5-114(2)(c), *supra* note 8.

¹¹ UCC § 5-114, Comment, § 5-109(2), UCP, General Provision (c), *supra* note 8.

¹² A bank which wrongfully refuses to honor a conforming demand on a letter of credit jeopardizes its reputation in international commerce, especially when another bank has already accepted and paid under a documentary demand and is seeking reimbursement from the bank which originally issued the letter of credit.

¹³ These two types of standbys were the most common letters of credit involved in the Iranian litigation.

The situation outlined below illustrates the use of a standby letter as a performance guarantee both before and after complete performance has occurred. In this case, as in the previous discussion of traditional letters, the buyer and the seller are separated by distance, legal systems, and a lack of mutual trust. Instead of wheat, which was an appropriate commodity in the previous situation, the goods involved in this case could be heat sensors for use in guided missile systems. For the sake of illustration, the bank parties involved are also different.¹⁴ This is partly because it is now the seller who is arranging for the standby letter instead of the buyer, who has insisted that the seller back up his heat sensors with a financial guarantee.¹⁵

In this case, the seller arranges with his bank in the U.S. to issue a standby letter of credit in favor of a bank in the buyer's country. Should the buyer decide that the seller has defaulted on the contract or that the goods do not perform as promised, the buyer may make a demand on his bank for payment under the standby letter of credit by giving his bank the documents required by the standby letter of credit contract. The buyer's bank pays the buyer and then informs the seller's bank that it has been required to pay the agreed amount of the standby letter of credit. In return, the seller's bank must pay the buyer's bank, and the seller is liable to his bank for the amount paid under the standby letter of credit.¹⁶

Considering the example above, it should be clear that the standby letter of credit is not intended to be drawn upon, whereas all the parties to a traditional letter of credit expect that the seller will demand payment for his goods once he has the required documents in hand.

It is also usually true as regards standby letters that the buyer must only produce a draft along with a document which states that the seller has defaulted in his performance of the contract, or that the goods do not perform as promised by the seller. Unlike the traditional letter of credit arrangement where at least some of the documents required are issued by a third party, such as shipping documents and documents of title, the

¹⁴ In letter of credit terms, the party requesting its bank to issue a letter of credit is called the bank's customer or the account party. The bank which originally issues the letters of credit is called the issuing bank. The foreign bank which accepts the documents and pays the demand is called a confirming bank; the demanding party is called the beneficiary. In a back-to-back credit arrangement such as this, there are really two letters of credit: one issued by the American bank for its customer naming the foreign bank as beneficiary, and one issued by the foreign bank naming the demanding party as beneficiary. The opportunity for confusion and misunderstanding is thus doubled. This article will use the terms interchangeably. UCC § 5-103, *supra* note 8.

¹⁵ If a transaction is international, the foreign bank involved may issue a guarantee, which unlike a letter of credit, allows the bank to look at elements of underlying contract. A guarantee is, therefore, more than a letter of credit; it is more like a surety bond. In the United States, banks are forbidden by law to issue financial guarantees of this kind. 12 U.S.C. § 24 (1976). Foreign branches of United States banks are allowed to issue financial guarantees. If a standby letter of credit is properly drafted, it is much less costly than a financial guarantee. This is true for both the bank and its customer because a financial guarantee requires the issuing bank to be as expert in the business matter for which the guarantee was issued. Without expertise the bank cannot make an intelligent decision on whether a demand for payment under the guarantee should be paid. A standby letter of credit, on the other hand, requires the customer, who will already have expertise, to seek injunctive relief when the paying bank is about to pay against an alleged fraudulent demand. UCC § 5-114(2) (b) *supra* note 8. Interestingly enough, the difference between standbys and guarantees was not discussed in the Iranian cases. In addition, the UCP does not allow guarantees in financial contracts containing the standard clause which states that the credit is subject to the UCP. UCP, Art. 8, *supra* n. 8.

¹⁶ UCC § 5-114(3), *supra* note 8.

documents for a standby letter of credit are produced by the buyer. This is an aspect of the commercial relationship which requires that the seller have a considerable amount of faith in the honesty of the buyer who could easily make a fraudulent demand with conforming documents. There can thus be no reliance on the impartiality of a third party issuer of documents in the standby credit arrangement unless such a third party issuer is required under the contract.

The differences between traditional and standby letters of credit have been briefly discussed above. Their simplicity and utility support their widespread use in many other forms as well.¹⁷ The risks and potential losses in standby letter of credit transactions are clearly far greater than in traditional letter of credit disputes.¹⁸ Yet, as has been mentioned, they are legally viewed as identical forms of commercial transactions. The courts are constrained to follow forms of judicial review developed well before the novel uses to which the standby letter of credit has been applied. As courts develop equitable remedies in their attempts to adjudicate fairly standby letters of credit disputes, there is a danger that the tremendous value of letters of credit will be undermined.

As the UCC specifically requires, unless the seller can legitimately allege some sort of fraud in the transaction, a court may not look at the underlying contract.¹⁹ Nevertheless, a court cannot, without looking to the provisions of the contract, determine the legitimacy of such a claim in a standby letter of credit dispute where the buyer claims that the seller has breached the underlying contract.

The same is true for the bank on whom the demand for payment is made. Although the seller may insist that the demand is fraudulent, the bank may not look beyond compliance with the documentary requirements of the letter of credit to determine the validity of its customer's assertion.²⁰ The seller must seek a court injunction against his bank disallowing payment under the letter of credit.²¹ Without an injunction, payment is made, and the seller must seek redress, usually in the foreign courts of the buyer's country, for wrongfully demanded payments by the buyer.²²

II. ISSUES INVOLVED IN LETTER OF CREDIT DISPUTES

A. *Nonconformity of Documents*

The courts, when confronted with an assertion that documentary demands under letters of credit are nonconforming, must determine whether a documentary demand is sufficiently nonconforming so as to enjoin payment,²³ or whether the inconsistencies of a

¹⁷ See note 2, *supra*.

¹⁸ The risks are greater because the beneficiary issues all documents required for a conforming demand, and the potential losses are greater because a standby credit involves no goods which might be used as collateral.

¹⁹ UCC § 5-114, *supra* note 8.

²⁰ *Id.*

²¹ *Id.*

²² In most, if not all of the contracts with the Imperial Government of Iran, the provisions required that disputes on the contract were to be adjudicated in Iranian courts. Such a provision is not uncommon in international contracts with governments in developing countries where the government has a strong bargaining position.

²³ *Courtaulds North America Inc. v. North Carolina National Bank*, 528 F.2d. 802 (4th Cir. 1975); *Insurance Company of North America v. Heritage Bank*, 595 F.2d 171 (3d Cir. 1979); see notes 53-85 and accompanying text.

demand are so minimal that an injunction should not be issued.²⁴ Secondary problems include the relationships of the demands on letters of credit to their corresponding expiration dates,²⁵ the duty of the paying bank to inform the beneficiary of nonconforming demands,²⁶ and the potential injury to international banks in a back-to-back credit arrangement when one bank has paid under conforming demands and the other bank has not paid due to nonconforming demands.²⁷

There is clearly a conflict among the circuits as to whether courts should adopt an equitable doctrine of substantial compliance, which allows for minor inconsistencies, or adhere to the more traditional strict compliance doctrine. Under this doctrine, the documents submitted must strictly comply with the terms of the letters of credit, or the issuing bank will not be obligated to pay the beneficiary.²⁸ The cases discussed below involve both traditional and standby letters of credit.

1. Strict Compliance

In *Chase Manhattan Bank v. Equibank and Air North Associates*, Equibank refused to honor Chase's demand for payment under a standby letter because Equibank found the initial demand to be nonconforming. A later proper demand was not honored because the expiration date on the letter had passed. The court of appeals vacated and remanded the district court's summary judgment for the defendant Equibank.²⁹

The circuit court based its decision to remand on the unresolved issue of whether or not Equibank had waived the timeliness requirement through one of its employees. The employee had allegedly told a Chase representative on the day of expiration that Chase could send the documents through Equibank's domestic collections. Such a method would delay delivery of the documents by several days, a fact commonly known in the banking business.³⁰ Nevertheless, despite the remand, which went against Equibank, the circuit court made several findings of fact in Equibank's favor which reaffirmed the doctrine of strict compliance. The court also outlined the different parties' obligations and rights in situations involving modifications and waivers.³¹

In this case, the three parties were involved in a long-term financing arrangement.³² In 1971, Chase agreed to provide Air North Associates with long-term financing for motel construction near Pittsburgh, Pennsylvania.³³ As a prerequisite for the loan agreement, Chase required a standby letter of credit in its favor which would be called upon if Air

²⁴ *Banco Espagnol de Credito v. State Street Bank and Trust Co.*, 385 F.2d 239 (1st Cir. 1967); *Flagship Cruises, Ltd. v. New England Merchants National Bank of Boston and Chemical Bank*, 569 F.2d 699 (1st Cir. 1978). See notes 86-142 and accompanying text.

²⁵ *Chase Manhattan Bank v. Equibank and Air North Associates*, 550 F.2d 882 (3d Cir. 1977); see notes 29-52 and accompanying text.

²⁶ *UCP supra*, note 8 at Art. 8(e).

²⁷ *Banco Espagnol de Credito v. State Street Bank and Trust Co.*, 385 F.2d 230 (1st Cir. 1967); see notes 86-118 and accompanying text.

²⁸ *Chase Manhattan Bank v. Equibank*, 550 F.2d 882 (3d Cir. 1977); *Courtaulds North America Inc. v. North Carolina National Bank*, 528 F.2d 802 (4th Cir. 1975); see notes 29-66 and accompanying text.

²⁹ *Chase Manhattan Bank v. Equibank*, 550 F.2d 882 (3d Cir. 1977).

³⁰ 550 F.2d at 886.

³¹ *Id.*

³² 550 F.2d at 884.

³³ *Id.*

North did not complete the loan transaction in accordance with the agreement.³⁴ At Air North's request, Equibank, a Pittsburgh bank, issued an irrevocable letter of credit in Chase's favor.³⁵ The letter provided for payment upon presentation of a sight draft accompanied by certification from Chase that Air North had defaulted.³⁶ The letter of credit for \$108,000 expired on April 30, 1973.³⁷

On April 27, when Air North did not appear for the scheduled closing of the loan agreement, Chase immediately sent a telex to Equibank which requested payment under the standby letter of credit. The telex failed to certify that Air North had defaulted, although both Equibank and Chase knew that Air North could have been declared in default weeks before April 27.³⁸ In fact, in letters sent by Chase to Equibank on April 10 and 26, Chase referred to items of construction not performed in accordance with the original commitment by Air North.³⁹ The letters, however, did not use the word "default," did not mention the letters of credit, and did not demand payment.⁴⁰ Chase asserted that the letters did certify that Air North had defaulted and so met the default document requirement of the standby. The circuit court stated that the "letters did not constitute certification of default as required by the letter of credit."⁴¹ The circuit court also agreed with the district court's "insistence upon strict compliance with the conditions stated in the letter of credit."⁴² The circuit court went one step further by holding Chase to a higher standard, noting that the strict compliance "requirement is all the more appropriate here where Chase, the beneficiary, must be presumed to be knowledgeable about banking practices."⁴³ In support of its conclusion, the circuit court cited UCC § 5-103(1)(a) which states "that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit."⁴⁴ The court also found support from the *Courtaulds* case in the Fourth Circuit which quoted Harfield: "There is no room for documents which are almost the same, or which will do just as well."⁴⁵ Although Equibank was aware of Air North's failure to meet its commitments, the court held that this does not excuse strict compliance with the terms of the letter of credit.⁴⁶ The court approvingly referred to Harfield's "fear that the sacred cow of equity will trample the tender vines of letter of credit law."⁴⁷ Finally, in regard to the nonconformity of Chase's demand, the court noted that "the utility and advantages of the letter of credit device would be considerably lessened were we to accept less than strict compliance. . . ."⁴⁸

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*; 12A PA. CONS. STAT. ANN. § 5103(1)(a) (Purdon 1970).

⁴⁵ 550 F.2d at 885 citing *Courtaulds North American Inc. v. North Carolina National Bank*, 528 F.2d 802, 806 (4th Cir. 1975); H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 73 (5th ed. 1974).

⁴⁶ 550 F.2d at 885.

⁴⁷ 550 F.2d at 885, n. 4; Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C.L.J. 7, 11 (1972).

⁴⁸ 550 F.2d at 885.

On the subject of the modification and waiver of obligations in letters of credit, the court continued to follow legal principles as opposed to equitable remedies. The court accepted the principle that an issuing bank may not modify an irrevocable letter of credit without its customer's consent, but held that a lack of consent does not per se prevent recovery by the beneficiary.⁴⁹

If the issuing bank by choice or inadvertence, waives a restriction in the letter of credit and pays the beneficiary despite the non-compliance, the issuer jeopardizes its right to reimbursement from its customer. The possibility that the issuer may not be able to recover from its customer, however, does not bar the beneficiary in his suit against the bank. The beneficiary bases his claim on the letter of credit as modified by the bank and acceptable to him — not on the agreement between the customer and the issuing bank, nor upon the underlying arrangement between customer and beneficiary.⁵⁰

In a final caveat, the court noted that on remand, "it must be determined whether Chase can claim reliance upon a conversation which occurred only three hours before the close of banking hours."⁵¹ Under the UCP which governed this particular letter of credit, "banks are under no obligation to accept presentation of documents outside their banking hours."⁵² In other words, Chase might have missed the expiration date anyway, whether or not it had been misled by the alleged modification.

In *Courtaulds North America Inc. v. North Carolina National Bank*, the circuit court for the Fourth Circuit reversed the district court's finding for the beneficiary, Courtaulds, and adhered to the strict compliance doctrine on documentary demands in letter of credit disputes.⁵³ In this case, which involved a traditional letter of credit used for the purchase and sale of knitting yarns, the issuing bank refused to honor Courtaulds' demand for payment. The bank's customer, Adastra, said it could not allow the bank to waive any discrepancies in the documentary demand because a trustee in bankruptcy had been appointed for Adastra. Adastra, therefore, no longer had the ability to waive discrepancies, as it had in the past.⁵⁴

The terms of the letter of credit required, among other things, that Courtaulds present a commercial invoice in triplicate stating that it covered 100,000 pounds, 100% Acrylic Yarn.⁵⁵ The main discrepancy was that the invoices stated that the goods were "Imported Acrylic Yarn" as opposed to "100% Acrylic Yarn,"⁵⁶ as required by the letter of credit terms.⁵⁷ Even though packing lists attached to the invoices clearly said that the goods were 100% Acrylic Yarn, the court held that packing lists could not be considered part of the invoice even though they were appended to it. Neither could the invoices be read as one with the lists.⁵⁸ In support of its conclusion, the court pointed to Article 9 of the UCP which states that "the description of the goods in the commercial invoice must

⁴⁹ 550 F.2d at 886.

⁵⁰ *Id.*

⁵¹ 550 F.2d at 887.

⁵² UCP *supra* note 8, at Art. 42.

⁵³ *Courtaulds North America Inc. v. North Carolina National Bank*, 528 F.2d 802 (4th Cir. 1975).

⁵⁴ 528 F.2d at 804.

⁵⁵ 528 F.2d. at 803.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ 528 F.2d at 806.

correspond with the description in the credit. In the remaining documents, the goods may be described in general terms."⁵⁹

During the life of the letter of credit, Courtaulds had often submitted non-conforming demands which failed to state on the invoices that the goods were 100% Acrylic Yarn.⁶⁰ Previously, the bank had always called Adastra and received approval of the documents before paying Courtaulds.⁶¹ Letter of credit law allows a bank's customer to waive discrepancies in documents.⁶² The court also noted that it is not the custom and practice in the banking trade for a bank to notify a beneficiary of any deficiencies in the draft or the documents, if they are waived by the customer.⁶³ The court then added that, "obviously, the previous acceptances of truant invoices cannot be construed as a waiver in the present incident."⁶⁴

Unfortunately for Courtaulds, by the time the bank received documents which conformed to the terms of the letters of credit, the credit had expired, so the bank legitimately refused again to honor the demand.⁶⁵ As the court pointed out, "no precedent is cited to justify retroactive amendment of the invoices or extension of the credit beyond the August 15 expiry of the letter."⁶⁶

This case is important in letter of credit law because it stands for the proposition that not only must all the documents required under the terms of the letter of credit be present, but each of them must also conform on their face to the terms of the credit.

Such a requirement is particularly useful in the standby letter of credit situation where only one or two documents prepared and delivered by the beneficiary are required. Thus, if a beneficiary does not conform his demands precisely to the terms of the letter of credit, he may find that his sloppy disregard of letter of credit law will bar his ability to collect, especially if he has waited until the last minute to make his demands. This may appear inequitable, but it should be remembered that Courtaulds could still sue Adastra on the contract since they received the goods for free. Of course, because Adastra was bankrupt, recovery might be slow and inadequate. The bank, however, would have been in the same situation as Courtaulds had it honored a non-conforming demand which Adastra could refuse to pay because the bank failed to adhere to the terms of the letter of credit.

In *Insurance Company of North America v. Heritage Bank*, another Third Circuit case, the court held that the Insurance Company of North America's ["INA"] demands for payment from Heritage Bank ["Heritage"] under a standby letter were nonconforming, even though the terms of the letter were so poorly worded that the court agreed with INA's contention that "no particular incantation was necessary."⁶⁷

In this case, a standby letter of credit was issued by Heritage with INA as beneficiary.⁶⁸ The purpose of the letter was to induce INA to post an appeal bond for Horace and Jean Billings who were appealing an adverse judgment that had been

⁵⁹ UCP *supra* note 8, at Art. 9.

⁶⁰ 528 F.2d at 804.

⁶¹ *Id.*

⁶² 528 F.2d at 807 *citing* the District Court's Findings of Fact, 387 F. Supp. 92 (M.D.N.C. 1975).

⁶³ *Id.*

⁶⁴ 528 F.2d at 807.

⁶⁵ 528 F.2d at 804.

⁶⁶ 528 F.2d at 807.

⁶⁷ *Insurance Company of North America v. Heritage Bank*, 595 F.2d 171, 175 (3rd Cir. 1979).

⁶⁸ 595 F.2d at 172.

entered against them by the Pennsylvania state court system.⁶⁹ Heritage issued the letter in the amount of \$78,673.00, the same amount as the appeal bond.⁷⁰ By its terms, the letter expired on October 21, 1977.⁷¹ The pertinent part of the letter required Heritage to honor INA's "drafts at sight accompanied by written evidence to the effect that . . . you [INA] have not received evidence satisfactory to you of the performance by the Principals of all its [sic] obligations in connection with which the aforesaid bond was issued."⁷²

Nine days before the expiration date of the standby letter of credit, the appeal was still pending.⁷³ Because there was apparently no provision for extension of the letter of credit, and because INA did not wish to find itself in the position of paying on the appeal bond after the letter of credit posted as security for that bond had expired, INA demanded payment.⁷⁴ As its demand, INA presented Heritage with a sight draft for the full amount of the appeal bond and certified that their liability under the bond was still outstanding.⁷⁵ When Heritage refused to honor INA's demand, allegedly at the request of its customers, the Billingses, INA filed suit seeking payment.⁷⁶ Meanwhile, the letter of credit expired, the Billingses lost their appeal, and INA was required to pay the judgment holder under the terms of the appeal bond.⁷⁷

The district court held that INA was not authorized under the terms of the letter of credit to demand payment in the circumstances outlined above, and that, even if they had been authorized to do so, under the rules of strict compliance, INA's demand failed to conform to the requirements of the letter of credit.⁷⁸ The court of appeals held, as did the district court that "under the appeal bond the Billingses were under no duty to exonerate INA from liability before the appeal was concluded so long as they prosecuted the appeal with effect, and that consequently it could not be said that the Billingses had not performed all their obligations at the time INA demanded payment from Heritage."⁷⁹ In addition, the circuit court concluded that even if Heritage had granted INA a blank check, as standby letters of credit often appear to be, it was "evident that INA did not properly fill in the blanks."⁸⁰ The circuit court adhered to the strict compliance doctrine of *Chase Manhattan v. Equibank*, *supra*, and rejected the persuasive reasoning of First Circuit cases discussed *infra*,⁸¹ which allow for only substantial compliance with letter of credit terms. The circuit court held that the fact that "the liability . . . is still outstanding"⁸² simply did not constitute "written evidence satisfactory to [it] of the performance by the [Billingses] of all [their] obligations in connection with which the aforesaid bond was issued."⁸³

The court goes on to substantiate its decision by pointing out that "any decision to the

⁶⁹ 595 F.2d at 171, 172.

⁷⁰ 595 F.2d at 172.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ 595 F.2d at 174.

⁸¹ See notes 86-142 and accompanying text.

⁸² 595 F.2d at 175.

⁸³ *Id.*

contrary would impose upon Heritage more than it had bargained for . . . and would threaten the foundations upon which the letter of credit has grown and flourished."⁸⁴ That foundation, the court added, is strict compliance, without which, "banks may become reluctant to assume the additional risks of litigation."⁸⁵

INA's loss can clearly be attributed to poor drafting of the letter of credit requirements. In particular it lacked a provision which would extend the expiration date; and terms which would define the obligations of the principals, should have been included.

2. Substantial Compliance

Despite the learned discourse on the advantages of the doctrine of strict compliance in letter of credit law, the First Circuit has attempted to reach equitable results in difficult cases by substituting strict compliance requirements for a doctrine of substantial compliance.

In *Banco Espagnol de Credito v. State Street Bank and Trust Co.*, the First Circuit reversed a lower court's ruling that documents presented to State Street by Banco Espagnol were nonconforming.⁸⁶ This case presents a confusing set of facts in a back-to-back credit arrangement involving traditional letters of credit. The letters were used to pay for clothes purchased from two Spanish manufacturers.

The buyer, Lawrence, contracted with two Spanish manufacturers, Alcides and Longeur, to purchase clothing.⁸⁷ As a condition of the contract, Lawrence was required to procure two traditional letters of credit naming the clothing manufacturers as beneficiaries.⁸⁸ This was done in a back-to-back credit arrangement with State Street acting as the issuing bank (the bank which issued the letters of credit for its customer, Lawrence), and Banco Espagnol acting as the advising bank (the bank which would advise State Street that it had received conforming documents and had paid the beneficiary, thus obligating State Street to pay Banco Espagnol). The letters of credit required signed invoices, inspection certificates, and full sets of "clean on board" ocean bills of lading dated not later than March 31, 1963.⁸⁹

The problems with this seemingly simple arrangement began because the parties to the contract had never decided who would issue the inspection certificates which were required under the terms of the letters of credit.⁹⁰ Finally, on March 1, 1963, the two letters of credit were amended to require an inspection certificate issued by Supervigilancia which would certify that "the goods were in conformity with the order."⁹¹

The next problem was to ascertain which of the documents involved in the transactions should have been considered as "the order" to which the inspected goods should have conformed. On the record, neither court could find any document purporting to be the order for goods manufactured by Longeur.⁹² To make matters even more confusing,

⁸⁴ 595 F.2d at 175, 176.

⁸⁵ 595 F.2d at 176.

⁸⁶ *Banco Espagnol de Credito v. State Street Bank and Trust Company*, 385 F.2d 230 (1st Cir. 1967).

⁸⁷ 385 F.2d at 231.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ 385 F.2d at 232.

⁹² *Id.*

the court found two sets of documents which could be called the orders for goods manufactured by Alcides.⁹³ After considering the details surrounding the issuing of the different orders, the courts concluded that a set of stock-sheets dated November 13, 1962, supplanted other documents dated a week earlier, despite the fact that the earlier documents were clearly marked as orders.⁹⁴ As a result of this conclusion, the court was faced with a notation found on the stock sheets (and not on the orders) which required that the coats and jackets were "to be as sample inspected in Spain."⁹⁵

Subsequent to March 12, 1963, the date on which the manufacturers requested Supervigilancia to begin inspection, Lawrence became concerned that the quality of the goods shipped might not be the same as the samples. Lawrence therefore sent a confusing barrage of cables to Spain.⁹⁶ The cables instructed Supervigilancia not to inspect the goods, nor issue a certificate, until it had received approved samples of the goods through Lawrence.⁹⁷ At this point, they were only five days away from March 31, the latest day the bills of lading could be dated and still conform to the requirements of the letters of credit.⁹⁸ Apparently at the insistence of the manufacturers, Supervigilancia proceeded with the inspection in a manner which they hoped was acceptable to Lawrence, though they hedged by issuing the inspection certificates "under reserves."⁹⁹ They then noted that this was not because of any problem with the goods, but because of the confusion and because of differences created by the cabled messages.¹⁰⁰

Supervigilancia had accepted samples for comparison from the manufacturers which, the manufacturers swore in front of a Public Notary, were the same as samples accepted by Lawrence's delegate when he was in Spain.¹⁰¹ The beneficiaries believed that was in conformance with the stock sheet requirement that the goods "be as sample inspected in Spain."¹⁰²

After receiving the inspection certificate, the manufacturers were able to meet the deadline date of March 31 for the bills of lading.¹⁰³ When all the required documents were issued to Banco Espagnol, the bank determined that the documents submitted appeared on their faces to comply with the terms of the credit. Banco Espagnol therefore honored them, and made payment on March 28 and 29.¹⁰⁴

State Street Bank, however, refused to honor Banco Espagnol's draft on it for payment under the letters of credit because State Street found the accompanying inspection certificates nonconforming to the terms of the credit.¹⁰⁵ Instead of the certificates certifying that the goods conformed to the order, State Street believed that the certificates merely indicated conformity to samples alleged by the seller to correspond to other samples allegedly approved by the buyer.¹⁰⁶ State Street also noted that the certificates

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ 385 F.2d at 233.

⁹⁶ 385 F.2d at 232.

⁹⁷ *Id.*

⁹⁸ 385 F.2d at 233.

⁹⁹ *Id.*

¹⁰⁰ 385 F.2d at 236.

¹⁰¹ 385 F.2d at 233.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

were not unqualified, as required by the letters of credit, but were issued under reserves, and were, therefore, unacceptable.¹⁰⁷

By adhering to the strict conformity doctrine, the district court sustained State Street's refusal to pay by finding that the certificates were nonconforming.¹⁰⁸ The First Circuit, however, in what could be considered a major departure from the strict compliance doctrine in letter of credit law, reversed the district court by holding that there is "some leaven in the loaf of strict construction. Not only does *haec verba* not control absolutely, . . . but some courts now cast their eyes on a wider scene than a single document."¹⁰⁹ As support for this assertion, the First Circuit cited one New York case,¹¹⁰ one British case,¹¹¹ and two law review articles.¹¹² The court goes on to differentiate between the long line of cases adhering to strict construction and its holding by noting that those cases "turn on discrepancies between the actual terms of invoices or bills of lading and requirements of a letter of credit."¹¹³ The difference in this case, the court asserted, was that the buyer was trying to ensure quality of the goods in conformity with its order. By so doing, the buyer "neglected to specify how it would conduct the inspection operation, leaving only the bland instruction that the goods must conform to the orders."¹¹⁴ The court went on to hold, "that [Supervigilancia] took the word, under oath, of the seller as to the appropriateness of the sample is no more than any inspector must ordinarily do."¹¹⁵ The court claimed that,

[t]o hold otherwise — that a buyer could frustrate an international transaction on the eve of fulfillment by a challenge to authenticity of sample would make vulnerable many such arrangements where third parties are vested by buyer with inspection responsibilities but where, apart from their own competence and integrity, there is no guarantee of the sample itself.¹¹⁶

Finally, with reference to the inspection certificate issued "under reserves," the court correctly noted the fact that the certificate was only issued under reserves because of the underlying dispute between the buyer and seller, "which could not be the concern of the advising bank."¹¹⁷ Of course, this assumes that the inspector could legitimately issue an inspection certificate while the parties to the transaction were still in dispute as to how the inspection should actually be conducted. Nevertheless, the First Circuit held that, "the inspection certificate in this case conformed in all significant respects to the requirements of the letter of credit."¹¹⁸ But if Lawrence could amend the letter of credit to specify Supervigilancia as the inspector, why couldn't he amend the bill of lading date to accommodate a proper inspection? If the parties had proceeded in this manner, rather than panicking over the March 31 deadline, this case would never have been considered by any court of law.

Eleven years after the First Circuit issued its opinion in *Banco Espagnol*, the court

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ 385 F.2d at 234.

¹¹⁰ *O'Meara v. National Park Bank*, 239 N.Y. 386, 146 N.E. 636, 39 A.L.R. 747 (1925).

¹¹¹ *Midland Bank Ltd. v. Seymour*, 2 Lloyd's List L.R. 147 (Q.B. 1955).

¹¹² Miller, *Problems & Patterns of the Letter of Credit*, U. ILL. L.F. 162, at 170, n. 45. (1959).

¹¹³ 385 F.2d at 234.

¹¹⁴ 385 F.2d at 236.

¹¹⁵ *Id.*

¹¹⁶ 385 F.2d at 237.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

reaffirmed its judicially constructed doctrine of substantial compliance in the case of *Flagship Cruises, Ltd. v. New England Merchants National Bank of Boston and Chemical Bank*.¹¹⁹ Although the First Circuit vacated and remanded the district court's summary judgment for the beneficiary based on questions of fact as to whether timely presentation of the documents required under the letter of credit had been made, the circuit court held that, "variance between documents specified [in a letter of credit] and documents submitted is not fatal if there is no possibility that the documents could mislead the paying bank to its detriment."¹²⁰

When applied to the actual facts of the case, the above statement does not appear to be so unreasonable. The danger, however, lies in the future use of portions of the opinion which could be taken out of the context of the particular facts to which it applied. This is especially dangerous here because of the extremely confusing fact pattern in *Flagship Cruises*.¹²¹ The ease with which the holding in this case could be misapplied may prove to be too much of a burden. With too great a risk of litigation, banks may not continue dealing in letter of credit unless some changes occur.

In this case, Chris Travel, Inc. of Rhode Island owed \$200,000 to Flagship Cruises, Ltd., a Bermuda corporation, for an unstated reason.¹²² Chris Travel's bank, Citizens Trust Co., requested Merchants Bank to issue an irrevocable letter of credit naming Flagship, an agent of Flagship Cruises, Ltd., as beneficiary.¹²³ The terms of the letter of credit required among other things,

[t]hat all drafts must be marked: 'drawn under NEMNB Credit No. 18506'; (4) that each draft must be accompanied by [Flagship's] signed statement that draft is in conjunction with the Letter of Agreement dated May 23, 1972 and Addendum dated June 15, 1972; (5) that drafts must be negotiated no later than November 3, 1972.¹²⁴

In October, 1972, Flagship delivered all the necessary documents to its bank, Chemical Bank.¹²⁵ There were several inconsistencies in the documents: Flagship Cruises, Ltd., as opposed to Flagship, was named as beneficiary,¹²⁶ the drafts did not say, "Drawn under NEMNB Credit No. 18506," but instead named Merchants in the draft and noted the number 18506 below the bank's name,¹²⁷ and the signed statement required from Flagship said the letter of credit, rather than "the draft" was in conjunction with the Letter of Agreement and the Addendum.¹²⁸

Unfortunately, the documents were not sent to Chemical's Letter of Credit Department, where they would have been examined and payment made immediately. Instead, the documents went to Chemical's International Collections Department, which merely forwarded the drafts to Merchants for payment.¹²⁹ The form forwarding the documents

¹¹⁹ *Flagship Cruises, Ltd. v. New England Merchants National Bank of Boston*, 569 F.2d 699 (1st Cir. 1978).

¹²⁰ 569 F.2d at 705.

¹²¹ 569 F.2d at 701, 702.

¹²² 569 F.2d at 701.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ 569 F.2d at 704.

¹²⁷ *Id.*

¹²⁸ 569 F.2d at 703.

¹²⁹ 569 F.2d at 701.

was dated November 3, but was not mailed until November 6, and, even then, Chemical neglected to include the required signed statements from Flagship.¹³⁰

By the time the documents, less the required signed statement, had arrived at Merchants on November 9, Chris Travel had gone bankrupt. Its bank, Citizens, had informed Merchants that since the credit had not been drawn upon on or before November 3, it should not be honored.¹³¹ Merchant informed Flagship's bank, Chemical, that the demand was nonconforming due to late presentation and the lack of the required signed statement.¹³²

Chemical, in an effort to cover for its mistake, sent notice to Merchants on November 13 that it had "negotiated" the documents by November 3, in conformance with Article 8 of the UCP, that the required signed statement had been inadvertently omitted when Chemical sent the other documents, and that it had been mailed and would arrive shortly.¹³³ By the time the required statement arrived on November 16, Merchants had already said it was too late.¹³⁴

On appeal, even the First Circuit thought the district court had stretched the doctrine of substantial compliance as applied in *Banco Espagnol*.¹³⁵ Though the First Circuit stopped far short of reversing its decision in *Banco Espagnol*, it did hold that the district court's finding that the draft was forwarded to Merchants Bank within a reasonable time, was not a question of law, but an unresolved question of fact.¹³⁶ Although the First Circuit did conclude that Flagship had "complied with the requirements of the letter of credit in every material respect,"¹³⁷ because a question of fact was held to exist, the First Circuit vacated and remanded the district court summary judgment for Flagship.

As regards the discrepancy between the naming of Flagship Cruises, Ltd. instead of Flagship as beneficiary, the First Circuit found that the required statement sent by Flagship to Chemical (and inadvertently omitted when documents were sent to Merchants) made clear that an agent-principal relationship existed between the two.¹³⁸ The First Circuit found compliance between the required references to Merchants and the number of the credit because it could not "see how the form actually used could be interpreted in any other way."¹³⁹ On the misstatement by Flagship that the letter of credit rather than the draft was in conjunction with the Letter of Agreement and the Addendum, the First Circuit viewed this as a case of the "greater including the smaller."¹⁴⁰ They went on to note that, "we don't see this kind of interpretation as relaxing the strict construction approach to letters of credit, but rather as equating a literal requirement with its functional equal."¹⁴¹

The First Circuit was clearly trying to protect Flagship's equitable right to payment under the letter of credit. Had the court held otherwise in regard to the discrepancies described above, Flagship's initial documentary demand for payment would have been

¹³⁰ *Id.*

¹³¹ 569 F.2d at 702.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ 385 F.2d 230 (1st Cir. 1967).

¹³⁶ 569 F.2d at 702.

¹³⁷ 569 F.2d at 705.

¹³⁸ 569 F.2d at 704.

¹³⁹ *Id.*

¹⁴⁰ 569 F.2d at 703.

¹⁴¹ *Id.*

nonconforming, and no bank would have been liable for payment. Flagship's only recourse would have been to file suit for payment against the bankrupt Chris Travel. Unfortunately, the First Circuit's "sacred cow of equity" has trampled the "tender vines" of letter of credit law by holding that documents which were almost, but not quite, the same, were sufficient.¹⁴²

B. *Fraud Under UCC § 5-114 and Case Law*

A bank's customer can only enjoin payment to a beneficiary who has made a conforming demand under a letter of credit by showing that a fraud has been perpetrated. The doctrine was first developed in *Sztejn v. J. Henry Schroder Banking Corporation*,¹⁴³ and later codified in UCC § 5-114. The doctrine protects buyers from sellers who have committed a fraud in a letter of credit transaction, usually by shipping worthless goods or by presenting falsified documents.¹⁴⁴ Normally a buyer who believes the seller has committed a fraud must seek an injunction from the appropriate court.¹⁴⁵ The burden is on the buyer to substantiate his allegation of fraud according to the appropriate court's rules of injunctive relief. Generally stated, an injunction will be granted when: (1) irreparable harm is shown; (2) there is a likelihood of success on the merits; (3) there is a lack of any other legal remedy; (4) extraordinary circumstances exist, (5) the balance of hardships is decidedly in favor of the party seeking relief; and (6) the public interest would be served by issuing an injunction. The UCC does not state when an injunction should be issued, which has left the courts free to apply local standards of injunctive relief.¹⁴⁶

The statute on fraud is an important exception to the general principle that letter of credit transactions should be scrutinized independently of the parties' obligations under the contract.¹⁴⁷ The statute allows the court to look to elements in the underlying contract to determine whether the beneficiary should be allowed to draw on the letter of credit.¹⁴⁸ Without this exception the seller could, by presenting documents which conformed on their face to the requirements of the letter of credit, commit a fraud. A buyer could not legally stop a seller from committing the fraud and collecting the money.

Under traditional letter of credit transactions, the determination of fraud is usually quite simple: if documents were forged showing that the goods were shipped when they were not, or if the goods shipped were worthless rubbish instead of what the buyer ordered, the seller has committed a fraud under § 5-114 of the UCC. The bank will be enjoined from making payment, and the letters of credit will be declared null and void.

¹⁴² See Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C.L.J. 7, 11 (1972).

¹⁴³ *Sztejn v. J. Henry Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

¹⁴⁴ Even though the UCP does not cover allegations of fraud, most courts have found that § 5-114 applies to letter of credit disputes even when the agreement specifies that the credit is governed by the UCP. This is so when the UCC § 5-114 has been adopted by the state in which the court sits, and the court reasons that there is no conflict between the UCP and the UCC on fraud. Therefore, the principles on fraud from the UCC or case law apply.

¹⁴⁵ An appropriate court is one which has both subject matter jurisdiction and personal jurisdiction over the party against whom the injunction is sought.

¹⁴⁶ Though there are some minor differences among the states on the requirements for injunctive relief, most, if not all of the 6 criteria listed above, are considered at some point by any court hearing arguments for equitable relief.

¹⁴⁷ Credits, by their nature, are separate transactions from the sales or other contracts on which they may be based and banks are in no way concerned with or bound by such contracts. UCP *supra* note 8, at General Provision (C).

¹⁴⁸ UCC § 5-114(2)(b) *supra* note 8.

If the bank has already paid, while another bank or its customer could not, the bank might be left with only fraudulent documents. In this situation, the statute protects the bank. Section 5-114 (2) (a) requires an issuing bank to pay any holder in due course or any negotiating bank¹⁴⁹ which has made payment and has accepted the documents as conforming and paid.¹⁵⁰ The questions then become when has a bank negotiated a letter of credit,¹⁵¹ and is a confirming bank always a holder in due course?¹⁵² As will be seen in Part III, the latter question becomes particularly important when dealing with a contracting government or agency, and a confirming government bank in the same country.¹⁵³ Under § 3-302 of the UCC, a holder in due course must take the letter of credit for value, in good faith, and without notice that it is overdue or has been dishonored. A holder in due course must also take the letter of credit without notice of any defense or claim to it by anyone else.¹⁵⁴

Greater problems arise when a standby letter of credit is involved. Because of the nature of the standby letter in international transactions, it is more difficult to apply the principles of fraud. As a result, it becomes more difficult to win injunctive relief.¹⁵⁵

1. Pre-Iranian Revolution Cases on Fraud

Cases arising after the Iranian Revolution were the first to involve allegations of fraud under UCC § 5-114 in a number of different circumstances.¹⁵⁶ U.S. corporations had millions of dollars in standbys which named Iranian government agencies as beneficiaries. These corporations were worried that unauthorized people might make fraudulent demands on the standbys. Because the standbys required so few documents to make a conforming demand for payment, usually confirmed and paid by a central Iranian government bank, there was a very real danger that U.S. companies, through their banks, would be required to pay fraudulent demands.

Cases decided before the Iranian Revolution illustrate the attitudes of courts faced with allegations of fraud where the plaintiffs seek to enjoin or force payment. Any discussion of fraud in relation to letters of credit must begin with *Sztejn v. J. Henry Schroder Banking Corporation*,¹⁵⁷ which established the right to enjoin the payment of a fraudulent demand on a letter of credit.

In *Sztejn*, the plaintiff, an American businessman, contracted to purchase bristles from Transea Traders, Ltd., an Indian corporation.¹⁵⁸ The goods were to be paid for by a traditional letter of credit issued by Schroder Banking Corporation [Schroder], which required that a draft, bill of lading, and invoices be presented to the Chartered Bank of

¹⁴⁹ A negotiating bank is sometimes used to expedite payment. The negotiating bank is located in the same place as the beneficiary who sells the draft to the bank making it a holder in due course entitled to payment from an issuing or confirming bank upon presentation of the draft and any required accompanying documents.

¹⁵⁰ See UCC § 3-302 *supra* note 8; UCP, *supra* note 8 at Art. 3(b).

¹⁵¹ Custom and usage in the banking industry allows up to three banking days or "reasonable time." This has been codified in § 5-112 of the UCC, *supra* note 8. See also, UCP *supra* note 8 at Art. 8(d).

¹⁵² See notes 121-129 and accompanying text.

¹⁵³ See notes 275-415 and accompanying text.

¹⁵⁴ UCC § 3-302 *supra* note 8.

¹⁵⁵ See notes 219-274 and accompanying text.

¹⁵⁶ See cases discussed in Part II.B.2.

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

¹⁵⁸ 177 Misc. at 720-721, 31 N.Y.S.2d at 633.

India [Chartered], Schroder's correspondent bank.¹⁵⁹ Chartered would then present the documents to Schroder for collection for the account of Transea.¹⁶⁰

After Transea had presented conforming documents to Chartered, and before Schroder had accepted the documents and paid under the conforming demand, Szejn sought an injunction to prevent Schroder from paying the amount due. Szejn alleged that the documents were fraudulent because the bristles described in the documents were not shipped by the seller.¹⁶¹ Transea had instead shipped crates of worthless rubbish and cowhair in an attempt to defraud Szejn and collect payment.¹⁶²

In granting the injunction and denying the Chartered Bank's motion to dismiss, the court first reaffirmed some of the principles of letter of credit law: "a letter of credit is independent of the primary contract of sale between the buyer and the seller."¹⁶³ Banks deal in "documents, not goods,"¹⁶⁴ and, conforming documents presented to a bank for payment must be honored.¹⁶⁵ A bank which is a holder in due course cannot be denied payment by the issuing bank.¹⁶⁶ The court then carved out an exception to these general principles by noting that the principles "presuppose that the documents accompanying the draft are genuine. . . ."¹⁶⁷ The court pointed out that this case did not involve a mere breach of warranty where the goods were inferior; here, the seller intentionally failed to ship any goods ordered by the buyer. The court concluded that in "such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller."¹⁶⁸ The court made clear that if a bank has exercised reasonable diligence in determining whether the documents conform, and has paid under the letter of credit before receiving notice of fraud, the bank will be protected even though the documents are forged or fraudulent.¹⁶⁹

Finally, the court stated that Chartered was not a holder in due course, but a "mere agent for collection for the account of the seller charged with fraud . . . If it had appeared that [Chartered] bank . . . was a holder in due course, its claim against the bank issuing the letter of credit would not be defeated even though the primary transaction was tainted with fraud."¹⁷⁰ As stated earlier, the court based its decision on the fact that the documents presented were fraudulent and did not represent the goods for which the parties to the underlying transaction had contracted.¹⁷¹ Thus, although the *Szejn* case supports the provisions in § 5-114 relating to fraudulent or forged documents, it is silent on what can be labelled "fraud in the transaction."¹⁷²

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ 177 Misc. at 721, 31 N.Y.S.2d at 634.

¹⁶⁶ 177 Misc. at 721, 31 N.Y.S.2d at 635.

¹⁶⁷ 177 Misc. at 721, 31 N.Y.S.2d at 634.

¹⁶⁸ 177 Misc. at 721, 31 N.Y.S.2d at 634.

¹⁶⁹ 177 Misc. at 723, 31 N.Y.S.2d at 635.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² There has been a continuing controversy over the question of which transactions fall within the scope of the statute. In their attempts to bring standby letters of credit within the scope of § 5-114, some courts have recognized that the entire transaction can be so tainted with fraud as to

As Harfield points out, the statute expanded the scope of *Sztejn* by including the phrase "fraud in the transaction."¹⁷³ The *Sztejn* case was decided on the basis of clear proof that the documents were forged and fraudulently represented the contents of the crates shipped.¹⁷⁴ "Fraud in the transaction" leaves room for the courts to make an equitable determination and base it on a relatively vague phrase. Other cases have, however, helped to define this concept.

In *United Bank Limited v. Cambridge Sporting Goods*,¹⁷⁵ the court suggested that "fraud in the transaction" comes into play when the contract for the underlying transaction has been legitimately cancelled.¹⁷⁶ Even though the underlying contract was cancelled, which required release of a letter of credit, the beneficiary still presented conforming documents for payment.¹⁷⁷ This is important to note because an otherwise casual reader might justifiably believe that the court based its determination of "fraud in the transaction" on the fact that the seller-beneficiary, Duke Sports, shipped old, mildewed boxing gloves instead of new gloves which were to have been manufactured according to the parties' agreement. The above situation fits the provisions in § 5-114 for the granting of an injunction when presented with forged or fraudulent documents: while they conform to the letter of credit requirements, they do not represent the goods for which the buyer contracted.

As noted by commentators, it would be redundant if "fraud in the transaction" meant the same thing as the presentation of forged or fraudulent documents.¹⁷⁸ The *Cambridge* case illustrates both possibilities under § 5-114 for enjoining payment of letters of credit: "fraud in the transaction" based on the fact that the contract was cancelled before a conforming demand was made,¹⁷⁹ and "forged or fraudulent documents" based on the fact that the documents showed that new boxing gloves had been shipped when only worthless old boxing gloves arrived.¹⁸⁰

The court, perhaps mistakenly, viewed the situation from a different perspective: "[w]e hold upon the facts as established, that the shipment of old, unpadded, ripped and mildewed gloves . . . constituted fraud in the transaction within the meaning of subdivision (2) of section 5-114. It should be noted that the drafters of § 5-114, in their attempt to codify the *Sztejn* case and in utilizing the term 'fraud in the transaction,' have eschewed the dogmatic approach and adopted a flexible standard to be applied as circumstances of a particular situation mandate."¹⁸¹ To conform to the reasoning of the *Sztejn* case, the court should have focused on the documents to see if they fraudulently misrepresented the goods shipped. Though the reasoning used may deserve equal credence, it is not the same.

This case is in a different context from most letter of credit cases. Cambridge, the buyer, had already won a default judgment against Duke, the seller. A preliminary

vitate the obligations under a letter of credit. See *Dynamics*, 356 F. Supp. 991 (1973). Others argue that "in the transaction" refers to the letter of credit itself. See UCC § 5-114, Comment 1 *supra* note 8.

¹⁷³ HARFIELD, H., LETTERS OF CREDIT, Uniform Commercial Code/Practice Handbook, American Law Institute (1979) p. 84 [hereinafter cited as LETTERS OF CREDIT].

¹⁷⁴ 177 Misc. at 721, 31 N.Y.S.2d at 633.

¹⁷⁵ 41 N.Y.2d 254, 392 N.Y.S.2d 265, 360 N.E.2d 943 (1976).

¹⁷⁶ See *supra* note 172.

¹⁷⁷ 41 N.Y.2d at 256, 392 N.Y.S.2d at 268, 360 N.Y.2d at 946.

¹⁷⁸ See LETTERS OF CREDIT, *supra* note 173.

¹⁷⁹ 41 N.Y.2d at 256, 392 N.Y.S.2d at 268, 360 N.E.2d at 946.

¹⁸⁰ 41 N.Y.2d at 260, 392 N.Y.S.2d at 271, 360 N.E.2d at 949.

¹⁸¹ 41 N.Y.2d at 260, 392 N.Y.S.2d at 271, 360 N.E.2d at 949.

injunction was granted which prohibited the issuing bank, Manufacturers Hanover Trust, from paying any drafts drawn under the letter of credit.¹⁸² Though the decision to issue the injunction was clearly based on § 5-114, it is not clear on which of the two possible frauds the court's decision was based.

The *Cambridge* case was instituted by two Pakistani banks, United Bank, Ltd. and the Muslim Commercial Bank, in the seller's country, which had allegedly financed the sale and had originally requested the issuance of the letter of credit for the amount of the contract price from Hanover Trust.¹⁸³ After the letter of credit had been issued, Duke informed Cambridge that it would be impossible to meet the time limit for manufacture and delivery as required by the contract, and requested an extension of the time for performance. Cambridge replied that, due to resale commitments, it could not agree to any extension.¹⁸⁴ Cambridge then advised Duke that the contract was cancelled and that the letter of credit should be released.¹⁸⁵ Cambridge, at the same time, notified United Bank that the contract had been cancelled.¹⁸⁶

Despite the cancellation and notice, almost a month later, Hanover Trust informed Cambridge that it had received a draft and the required documents from United, allegedly showing the shipment of the boxing gloves under the terms of the cancelled contract.¹⁸⁷ The draft was drawn by Duke upon Hanover Trust and made payable to United for the amount of one-half of the letter of credit.¹⁸⁸ A month later Hanover Trust received similar documents from the Muslim Bank, the draft made payable to it, requesting payment of the other half of the letter of credit.¹⁸⁹

The Pakistani banks brought this action claiming their right to payment as holders in due course. They claimed they were entitled to payment, despite any defenses that Cambridge may have had against Duke.¹⁹⁰ The court of appeals reversed the trial court's directed verdict and the appellate division's affirmation, holding that the defense of fraud in the transaction was established and in that circumstance the burden shifted to petitioners to prove that they were holders in due course, that they took the drafts for value, in good faith, and without notice of any fraud on the part of Duke.¹⁹¹ The court, citing *Banco Espagnol*¹⁹² went on to say that, "in the context of a letter of credit transaction and, specifically subdivision (2) of section 5-114, it is these defenses which operate to shift the burden of proof of holder in due course status upon one asserting such status."¹⁹³

In *Intraworld Industries, Inc. v. Girard Trust Bank*,¹⁹⁴ a standby letter of credit was set up by a lessee. The standby was payable to the lessor if the lessee failed to pay rent on a Swiss hotel according to a certain payment plan. The Pennsylvania Supreme Court refused to grant an injunction despite the lessee's allegations of fraud in the underlying transaction.¹⁹⁵ The lessee argued that the lease had been cancelled and rent, therefore, was not

¹⁸² 41 N.Y.2d at 256, 392 N.Y.S.2d at 268, 360 N.E.2d at 946.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ 41 N.Y.2d at 257, 392 N.Y.S.2d at 269, 360 N.E. at 947.

¹⁹¹ 41 N.Y.2d at 258, *id.* 360 N.E.2d at 950.

¹⁹² *Banco Espagnol*, 385 F.2d 230 (1967).

¹⁹³ 41 N.Y.2d at 262, 392 N.Y.S.2d at 272, 360 N.E.2d at 950.

¹⁹⁴ 461 Pa. at 343, 336 A.2d 316 (Pa. 1975).

¹⁹⁵ 461 Pa. at 354, 336 A.2d at 322.

due.¹⁹⁶ The lessee further argued that the demand was fraudulent because it was not for rent due, as stated in the documents, but for a stipulated penalty pursuant to an addendum of the lease.¹⁹⁷

In denying the injunction, the court noted that,

[i]n light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit, we think that the circumstances which will justify an injunction must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.¹⁹⁸

The court then concluded that, "if the documents presented by [the lessor] are genuine in the sense of having some basis in fact, an injunction must be refused. An injunction is proper only if [the lessor], comparable to the beneficiary in *Sztejn*, has no bona fide claim to payment under the lease."¹⁹⁹

The decision seems to be based on facts showing that the lessee had failed to pay rent and other operating bills of the hotel in excess of \$100,000. In addition, the lessee had violated Swiss law by failing to complete the board of directors of its Swiss subsidiary and had refused to account to the lessor for the difficulties and apparent mismanagement.²⁰⁰ The facts were sufficient for the court to find that the documents had some basis in fact and that the lessor might have a bona fide claim.²⁰¹

As support for its decisions, the court cited *Dynamics Corporation of America v. Citizens and Southern National Bank*, which involved a standby letter of credit naming the government of India as beneficiary.²⁰² This case bears several similarities to the Iranian cases: the letter of credit was called upon as a result of political disturbance surrounding the emergence of Bangladesh as a nation. The Indian aggression resulted in a U.S. ban on the export of the goods produced by Dynamics for India.²⁰³

In this case, Dynamics contracted to sell defense-related communications equipment to the government of India.²⁰⁴ The Agreement obligated Dynamics to manufacture the equipment, deliver it "F.O.B. its plant,"²⁰⁵ and to provide technical assistance to India to ensure the equipment's proper use. Under the contract, Dynamics was required to secure good performance of its obligations with a standby letter of credit which required only a draft and certification by the President of India that Dynamics had "failed to carry out certain obligations of theirs under the said Order/Agreement."²⁰⁶ When war erupted between India and Pakistan, the U.S. barred shipment of the goods.²⁰⁷ When the Indian government failed to make payment against Dynamics' invoices, Dynamics was forced

¹⁹⁶ 461 Pa. at 359, 336 A.2d at 324.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ 461 Pa. at 361, 336 A.2d at 325.

²⁰⁰ 461 Pa. at 351, 336 A.2d at 320.

²⁰¹ See 461 Pa. at 361, 336 A.2d at 325.

²⁰² 356 F. Supp. 991 (N.D. Georgia 1973).

²⁰³ 356 F. Supp. at 993, 994.

²⁰⁴ 356 F. Supp. at 993.

²⁰⁵ 356 F. Supp. at 996.

²⁰⁶ 356 F. Supp. at 994 n. 2.

²⁰⁷ 356 F. Supp. at 994.

into bankruptcy.²⁰⁸ Two months after filing for bankruptcy, and two days before the letter of credit was due to expire, India presented a sight draft to the issuing bank with the required certification that Dynamics had failed to carry out their obligations under the contract.²⁰⁹ Fortunately for the bank, Dynamics had already gotten a temporary restraining order against the bank paying any demand on the standby.²¹⁰

Dynamics based its allegations of fraud on the contract provision which obligated it to supply the equipment F.O.B. its plant, which they had done.²¹¹ In other words, it was India's responsibility to get the goods to their country, not Dynamics'. Dynamics had therefore performed, and India's certification to the contrary was fraudulent.²¹²

In support of its decision to issue a preliminary injunction as sought by Dynamics, the court noted that, "[t]he law of 'fraud' is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society."²¹³ As a caveat to their decision, the court made clear that,

"Since . . . this court has no business making an ultimate adjudication regarding compliance with the provisions of the underlying sales agreement, India will not be required to *prove* that [Dynamics] 'failed to carry out certain obligations of theirs' under the Agreement in order to get payment from the Bank. Rather, the court views its task in this case as merely guaranteeing that India not be allowed to take unconscientious advantage of the situation and run off with plaintiff's money on a pro forma declaration which has absolutely no basis in fact. If it should turn out that there is a legal and factual basis for India's certification, the court will leave the plaintiff to its remedy at law."²¹⁴

This case clearly runs counter to the decisions in *Intraworld Industries*²¹⁵ and *Bossier Bank and Trust Co. v. Union Planters National Bank of Memphis*,²¹⁶ but it is questionable whether a case allowing a preliminary injunction should be considered as precedent in a case seeking a permanent injunction. While a preliminary injunction preserves the status quo,²¹⁷ a permanent injunction is an equitable remedy. It is granted when the court is faced with extraordinary circumstances and no other remedy at law. It is important to note here that a standby letter of credit often has no relation to the total contract price in international transactions other than as a percentage,²¹⁸ or an invoice amount as in this case. Therefore, it does not matter how much, if any, of the contract price should be allocated to the contract provision requiring Dynamics to provide technical assistance. It was a "certain condition" to the contract, as stipulated in the letter of credit. Considering this line of argument, a preliminary injunction should not even have been issued, despite

²⁰⁸ 356 F. Supp. at 995.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ 356 F. Supp. at 996.

²¹² *Id.*

²¹³ 356 F. Supp. at 998.

²¹⁴ 356 F. Supp. at 999; remedy would be binding arbitration in India.

²¹⁵ 461 Pa. 343, 336 A.2d. 316.

²¹⁶ *Bossier Bank and Trust v. Union Planters National Bank*, 550 F.2d 1077 (6th Cir. 1977).

²¹⁷ This is at least the perspective from which the court in the *Dynamics* case viewed preliminary injunctive relief. The court then noted the factors to be considered: importance of the rights asserted, nature of acts to be enjoined, hardships if the injunction is granted or denied, likelihood of success on the merits, and public interest. 356 F. Supp. at 999.

²¹⁸ See notes 280-295 and accompanying text.

the status quo reasoning of the court. India had complied with the terms of an outstanding letter of credit, and it was clear on the facts that Dynamics could not perform. Thus, under the terms of the credit, India had a right to call on the standby.

2. Allegations of Fraud in the Iranian Cases

The standby letter of credit cases which arose after the Iranian Revolution are important because of the novel arguments advanced in favor of injunctions. U.S. companies which had the standbys issued naming the Iranian government or one of its agencies as beneficiary, had assumed the good faith of the Shah's pro-American government. Because of the Shah's good faith and Iran's superior bargaining power due to the heavy competition for contracts, the standbys required few, if any, documents for a conforming demand requiring payment.²¹⁹ Thus, once the anti-American Islamic Republic of Iran came to power, the standbys became weapons in the hands of a legitimate but unfriendly State successor to the Imperial Government.

Although the injunction suits were brought before demands had been made on the standbys, it was clear to those involved that such demands were very likely. The standbys were susceptible to conforming, though perhaps arbitrary or fraudulent, demands. In view of the Islamic Republic's well-publicized hatred for the United States, what better way to disrupt American business than to repudiate all contracts and then to make conforming demands on all available standby letters of credit still outstanding, regardless of whether or not the demands were legitimate?

There is no definitive system used in presenting these arguments.²²⁰ Some authors base their discussion on the stage of completion of the contracts,²²¹ others on the type of injunctive relief awarded,²²² if any. Others discuss the novelty of the arguments and their future utility.²²³ This section will combine these approaches while focusing on the precedential value of these arguments in future letter of credit controversies.

a. Nonconformity of Demand — the Wrong Sovereign Beneficiary Claim

The claim that the new sovereign is an illegitimate beneficiary is perhaps the best losing argument asserted in many of the Iranian cases. The principle is supported in both the UCC²²⁴ and the UCP,²²⁵ which agree that the beneficiary's right to demand payment on a letter of credit is not assignable,²²⁶ unless the letter of credit so provides or the parties agree. It is therefore argued that without the consent of the bank's customer, the Islamic

²¹⁹ See notes 325-363 and accompanying text.

²²⁰ Getz, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L L. J. 189 (1980); Weisz and Blackman, *Standby Letter of Credit After Iran: Remedies Of the Account Party*, 1982 U. ILL. L. REV. 355 [hereinafter cited as *Remedies Of the Account Party*]; Note, "Fraud In The Transaction"; *Enjoining Letters Of Credit During The Iranian Revolution*, 93 HARV. L. REV. 992 (1980) [hereinafter cited as *Enjoining the Standby*]; Note, *The Role Of Standby Letter Of Credit In International Commerce: Reflections After Iran*, 20 VA. J. INT'L L. 459 (1980) [hereinafter cited as *Reflections After Iran*].

²²¹ *Fraud in the Transaction*, *supra*, note 220.

²²² *Enjoining The Standby*, *supra*, note 220.

²²³ *Remedies of the Account Party*, *supra*, note 220; *Reflections After Iran*, *supra*, note 220.

²²⁴ UCC § 5-116(1), *supra* note 8.

²²⁵ UCP *supra*, note 8 at Art. 46(d).

²²⁶ It is important to understand that the beneficiary may assign his right to payment, but he may not assign his right to make the demand for payment.

Republic of Iran or one of its agencies, substituted itself as beneficiary in place of the Imperial Government of Iran. This would be a violation of letter of credit law, thus entitling the account party to the injunctive relief sought. Such an assertion is further supported by the doctrine of strict conformity which requires strict compliance with the terms of the credit, including the name of the beneficiary.²²⁷

The doctrine of state succession, however, conflicts with the non-assignability of letters of credit and the strict conformity doctrine. The doctrine of state succession holds that when the new government of a State is recognized, it succeeds to all the contractual rights and obligations of the old government.²²⁸ Without fail, the courts rejected non-assignability and strict conformity and accepted the doctrine of state succession.²²⁹

b. Anticipatory Fraud — Demands by Parties with Unauthorized Access to Bank Records and Telex Machines

Anticipatory fraud was argued by parties on whom no demand had yet been made, but who believed that anti-American revolutionary forces could gain unauthorized access to bank records and bank telexes. Such an assertion, although based on allegations of fraud, was not without some basis in fact. It would have been very easy for revolutionary forces to assume that the Iranian banks were hotbeds of capitalist, pro-American sympathizers. In the *Werner Lehera*²³⁰ case, the plaintiff, in its effort to enjoin payment of a letter of credit, alleged that the responsible official "was in the process of issuing the final written preliminary acceptance when he was arrested by armed revolutionary forces."²³¹

The courts in rejecting such claims of anticipatory fraud, looked to the elements which would justify granting a preliminary injunction. They concluded that such allegations were too speculative to reach the threshold of irreparable harm.²³² Nevertheless, this argument convinced the courts to grant notice injunctions of three, ten, fifteen or twenty days.²³³ These injunctions required the bank to give notice to the U.S. company that the bank had received a conforming demand on a standby. The injunctions also required the banks not to pay on demand until the customer could determine the authenticity of the demand.²³⁴ If the customer could gather enough facts in the time allotted to show that the demand had been made by unauthorized persons, the court might be persuaded to grant an injunction.

²²⁷ See *Chase Manhattan Bank v. Equibank*, 550 F.2d 882 (3rd Cir. 1977); *Courtaulds North America, Inc. v. North Carolina National Bank*, 528 F.2d 802 (4th Cir. 1975).

²²⁸ See, e.g., *Guaranty Trust Co. v. United States*, 304 U.S. 120 (1938); RESTATEMENT (SECOND), FOREIGN RELATIONS LAW OF THE UNITED STATES § 107 comment (c) (1965).

²²⁹ Obviously, such an approach in no way affects the letter of credit laws as they apply to non-governmental beneficiaries.

²³⁰ *Werner Lehera International, Inc. v. Harris Trust & Savings Bank*, 484 F. Supp. 65 (W.D. Mich. 1980).

²³¹ 484 F. Supp. 65.

²³² See *KMW International v. Chase Manhattan*, 606 F.2d 10, 15 (2d Cir. 1979).

²³³ *Werner Lehera*, supra, n. 230 (3 day notice injunction granted; preliminary injunction denied); *KMW International v. Chase Manhattan*, 606 F.2d 10 (2d Cir. 1979) (injunction vacated; 3 day notice injunction granted); *Harris Int'l Telecommunications v. Bank Melli Iran*, 79 Civ. 802 (S.D.N.Y. Feb. 22, 1979) (10 day notice injunction granted); *Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (S.D.N.Y. 1979) (10 day notice injunction granted); *CBA Int'l Dev. Corp. v. European Am. Bank & Trust, N.Y.L.J.*, June 26, 1979, at 6. Col. 4 (N.Y. Sup. Ct.) (15 day notice granted); *Pan Am. World Airways, Inc. v. Bank Melli Iran*, No. 79-1190 (S.D.N.Y. Apr. 3, 1979) (20 day notice injunction against Bank Melli paying under its guarantees).

²³⁴ See cases cited in note 233, supra.

Recognizing that the notice injunctions effectively added a provision to the terms of the standbys without the consent of all parties, the courts pointed out that the time delay was consistent with the reasonable time period allowed by both the UCC²³⁵ and the UCP.²³⁶ Because of the extraordinary circumstances in Iran, such notice injunctions merely allowed for a sufficient time period to verify a demand. The use of notice injunctions was also supported by the principle of letter of credit law which holds that conforming documents must be genuine to entitle the beneficiary to payment.²³⁷

Plaintiffs in similar situations who were denied notice injunctions found themselves in a quagmire when conforming documents had been submitted and payment made. The plaintiffs' cases would be moot by the time they were ripe.²³⁸ By then, their only method of repayment would be on the contract, against Iranian sovereign beneficiaries. In the Iranian courts,²³⁹ the chances of a successful outcome would have been slim; they could also have been subjected to counter-claims for crimes against the Iranian people.²⁴⁰

c. Politically Motivated Demands

Many believe that the granting of a preliminary injunction in the *Dynamics*²⁴¹ case can be used as precedent to justify injunctions when a sovereign beneficiary makes an arbitrary demand based on political motivations.²⁴² The court in the *American Bell*²⁴³ case recognized such a possibility, but placed the burden of proof on the customer to show that the demand was politically motivated and not based on commercial or economic considerations.²⁴⁴ Even where the customer is able to show political motivation, the beneficiary still has the power to dissolve the injunction if it can show some economic or commercial basis in fact for the demand.²⁴⁵

Thus, although the claim is available to those seeking injunctions, the burden of proof is very high where facts, by the nature of the situation, are scarce. The beneficiary may easily, perhaps even fraudulently, rebut the assertion.

d. Conflict and Precedent Surrounding Allegations of Political Turmoil as the Equivalent of Fraud

Two cases decided by the New York Supreme Court in 1941 established conflicting precedents regarding political turmoil which threatened to frustrate international transactions. The question was whether political turmoil could be viewed as the equivalent of fraud for purposes of seeking an injunction against facially conforming demands. Both

²³⁵ UCC § 5-112, *supra* note 8.

²³⁶ UCP *supra* note 8 at Art. 8(d).

²³⁷ See *Sztejn supra* n. 143 at 634.

²³⁸ *Enjoining the Standby, supra* note 220, at 218 and accompanying notes.

²³⁹ Most, if not all, of the contracts with the Iranian Government, required that disputes on the contract be settled according to Iranian law and in the Iranian court system.

²⁴⁰ This is not so far fetched when one considers the animosity against the United States displayed by the Islamic Republic during the Hostage Crisis and the accusations made suggesting criminal conduct in the activities between the Shah and the American companies.

²⁴¹ *Dynamics*, 356 F. Supp. 991.

²⁴² *Id.*

²⁴³ *American Bell International v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979).

²⁴⁴ 474 F. Supp. at 425.

²⁴⁵ *Dynamics*, 356 F. Supp. at 999.

*Grob v. Manufacturers Trust Co.*²⁴⁶ and *Nadler v. Mei Loong Corporation of China*²⁴⁷ involved traditional letters of credit.

In *Grob*, the buyer-customer had arranged to have Japanese ships pick up and deliver the goods.²⁴⁸ The buyer's bank would make payments under the letter of credit against bills of lading submitted by the Chinese seller.²⁴⁹ The buyer alleged that, considering the major political upheaval caused by the Japanese in the Pacific, the Japanese ships would issue the required bills of lading and then never deliver the goods.²⁵⁰ In denying the motion for injunction, the *Grob* court held that to do otherwise "would be nothing other than shifting to the sellers or the defendant [issuer bank] risks which the plaintiff has contracted to assume."²⁵¹

Only a month later, the same court granted an injunction in *Nadler*²⁵² based on facts similar to *Grob*. The only apparent difference was that by this time the Japanese had invaded China.²⁵³ Thus, *Nadler* held that "these are extraordinary times in which ordinary business standards and strict legal rules must be examined specially and perhaps disregarded in the interests of justice and equity."²⁵⁴

Unfortunately for customers seeking injunctions, the Second Circuit, in *KMW International v. Chase Manhattan Bank*,²⁵⁵ held that *Grob* controlled. The court rejected the idea that political turmoil is the equivalent of fraud for purposes of granting an injunction.²⁵⁶ Because the customers had subjected themselves to the risks and hazards of doing business in foreign countries, the court held that shifting those risks was unwarranted.²⁵⁷ Once again, a U.S. court had adhered to legal rules in letter of credit law and rejected a claim for equitable relief.

e. Impossibility of Performance as a Basis for Asserting Fraud in the Transaction

In the *KMW* case, the lower court accepted the argument that impossibility could justify an injunction. The court held that a letter of credit should not be honored "where there is a considerable danger that the transaction will be frustrated by . . . fraud, supervening illegality, insurrection, or war."²⁵⁸ The Second Circuit reversed, finding nothing in letter of credit law "which excuses an issuing bank from paying a letter of credit because of supervening illegality, impossibility, war, or insurrection."²⁵⁹ Clearly, the more one looks at these arguments, the more one wonders when an injunction in a close case should issue under a court's equitable powers. In any event the argument failed, though *Nadler* was not specifically overruled, and the court closed one more door to equitable relief in letter of credit controversies.

²⁴⁶ 177 Misc. 45, 29 N.Y.S.2d 916 (Sup. Ct. 1941).

²⁴⁷ 177 Misc. 263, 30 N.Y.S.2d 323 (Sup. Ct. 1941).

²⁴⁸ 177 Misc. at 45, 29 N.Y.S.2d at 916.

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ 177 Misc. at 45, 29 N.Y.S.2d at 916.

²⁵² 177 Misc. at 265, 30 N.Y.S.2d at 324.

²⁵³ See *Reflections After Iran*, *supra*, note 220 at 487.

²⁵⁴ 177 Misc. at 264, 30 N.Y.S.2d at 324.

²⁵⁵ 606 F.2d 10 (2d Cir. 1979).

²⁵⁶ 606 F.2d at 16.

²⁵⁷ 606 F.2d at 17.

²⁵⁸ No. 79-1067 (S.D.N.Y. Mar. 9, 1979), *aff'd on rehearing* (Mar. 16, 1979) Slip Op. at 21.

²⁵⁹ 606 F.2d at 16.

f. Foreign Court Decisions in the Iranian Cases as Support for the Fraud Argument

Some customers in their briefs seeking injunctive relief cited several European cases, which, though not subject to the UCC, held that arbitrary or fraudulent demands justified relief. In *Collins Systems International, Inc. v. Chase Manhattan Bank and Bank Mallat*, the Parisian Court of Commerce held that a demand on a standby was fraudulent and abusive.²⁶⁰ In *Fortres-Icas Continental Associates v. Algemene Bank Nederland N.V.*, the District Court of Amsterdam held that a demand was fraudulent and arbitrary.²⁶¹ In *Alfa-Laval AB v. Bank of America National Trust and Savings Bank v. Bank Melli and Iran Dairy Industries Co.*, the Commercial Court of Brussels held that a demand was abusive and in bad faith.²⁶²

Though it is not clear whether U.S. courts give any credence to these decisions, it is certainly worthwhile to consider them. From the banks' perspective, the more injunctions that are granted, the less the banks' reputations will suffer in international commerce, and the better off their customers seeking equitable relief will be.

g. International Law in Support of Injunctive Relief

One author artfully argues that a court could issue an injunction based on fraud when the customer's ability to challenge retention of the money paid under a letter to a sovereign beneficiary has been effectively eliminated.²⁶³ This could occur either because of a change in the municipal law of the country in which the customer must bring his claim, or because of an effective denial of access to those courts in which the parties to the contract have agreed to settle their disputes. The argument is:

A party contracting with a foreign sovereign has the right, under international law, to the protection of the laws of the sovereign at the time of contracting. Accordingly, if a sovereign attempts to draw upon an unconditional letter of credit when it is in breach of its state responsibilities to an alien contracting party, then payment on the demand is not within the risks allocated to the alien party by the letter of credit terms. In such a case, the expectations of the parties would only be effectuated by a decision granting injunctive relief.²⁶⁴

According to this line of reasoning, U.S. companies must have an effective opportunity to pursue the remedies under Iranian law as it existed at the time of contracting. Obviously, that opportunity did not exist at the time the Iranian cases were brought before the U.S. courts.

h. Satisfying the Elements of Injunctive Relief

Many of the arguments discussed above were made in an effort to satisfy one or more of the elements of injunctive relief. If any lesson is to be learned from the courts' decisions in the Iranian cases, it is that the standards are very high, and the burden of proof decidedly heavy on the bank's customer. He must show that the elements of injunctive relief are thoroughly proved in his favor, thus justifying relief. Perhaps the greatest difficulty faced by the U.S. companies in these cases was the gathering of facts in support of their assertions.

²⁶⁰ Court of Commerce of Paris (Feb. 12, 1982).

²⁶¹ Case No. KG80/1065 District Court of Amsterdam.

²⁶² Case No. 2920, Commercial Court of Brussels (April 6, 1982).

²⁶³ *Enjoining the Standby*, *supra*, note 220 at 242.

²⁶⁴ *Id.* at 243.

When no demand on a standby had been made, the courts held that the likelihood of irreparable harm was too speculative.²⁶⁵ At best, the courts granted the plaintiff a notice injunction. If a demand had been made, the task was slightly easier: the bank's customer needed to show that the forum in which he would be required to recover the money on the contract would no longer be available. At the very least, he would have to show that the foreign courts were unlikely to adhere to notions of fair play and due process.²⁶⁶

The "lack of any other legal remedy" criteria can be argued in much the same way as irreparable harm. Some courts, however, could not be persuaded and held, as they did in *Werner Lehera*²⁶⁷ that, "[s]hould Harris [the issuing bank], upon demand, make payment to Bank Melli in violation of the letter of credit, no question exists that money damages from Harris could be awarded."²⁶⁸ Though this is true, Werner Lehera, like many other customers in these cases, was not concerned that Harris would make a payment in violation of letter of credit law. Rather, Werner Lehera was concerned that Bank Melli would arbitrarily or fraudulently demand payment with conforming documents. Harris would inspect the documents, find them conforming, and pay; Werner Lehera would owe Harris the amount paid under the letter of credit, regardless of whether or not the demand had been legitimate. It is interesting to note that the principal potential perpetrator of fraud in the Iranian cases was seldom, if ever, a defendant. This was the sovereign beneficiary under the letters of credit.

Compared to the beneficiaries of the standbys, who merely had to make a conforming demand for payment and then force the customer to litigate in Iranian courts, the customers had the balance of hardships clearly tipped in their favor. Most courts, however, did not view the situation in this way: they considered the balance of hardships to be between the customer and the issuing bank.²⁶⁹ From this perspective, the banks in many cases were able to convince the courts that the balance of hardships tipped considerably in their favor. The banks' winning arguments included: (1) damage to their credibility in international commerce if they were unable to pay on irrevocable letters of credit,²⁷⁰ (2) the potential for retaliatory action against the banks' assets in Iran, including nationalization and attachment,²⁷¹ and (3) a shifting of risks which goes against the contract principle that as between two innocents, the party who undertakes the risks by contract "must bear the consequences when the risk comes home to roost."²⁷² Though this is certainly a credible axiom when considered with the banks' other contentions, at least one commentator has noted that if the Islamic Republic wanted, it could take retaliatory action against the banks based on false charges or for no reason at all.²⁷³ In addition, as several courts have noted, there is as much interest in discouraging fraud as there is in preserving the independence of letters of credit.²⁷⁴ Not only does this suggest that banks enjoined should

²⁶⁵ See cases cited, *supra*, note 233.

²⁶⁶ Though several account parties were able to show this element of injunctive relief, their failure (according to the courts) to satisfy other elements of injunctive relief made the showing an empty victory.

²⁶⁷ 484 F. Supp. at 65.

²⁶⁸ 484 F. Supp. at 74.

²⁶⁹ See *Chase*, *supra*, n. 227, *Werner Lehera*, *supra*, note 230.

²⁷⁰ See *KMW*, 606 F.2d at 17; *American Bell*, 474 F. Supp. at 426.

²⁷¹ 474 F. Supp. at 426.

²⁷² *American Bell*, 474 F. Supp. at 426.

²⁷³ See *Reflections After Iran*, *supra*, note 220 at 491, n. 202.

²⁷⁴ *Dynamics*, 356 F. Supp. at 1000.

not suffer any loss of reputation, but it also suggests a public interest in courts properly adjudicating the conflict between the two principles.

With reference to the probability of success on the merits, there were no clear lines drawn by the courts, principally because there were very few identical sets of facts in the Iranian cases. The courts did, however, make use of the fraud exception and looked to aspects of the underlying contract and its performance.

III. THE ITEK CASE

The *Itek* case is the only U.S. case in which a permanent injunction was granted at the district court level. A U.S. bank was enjoined from honoring a demand for payment by an Iranian bank under standby letters of credit held for the benefit of an Iranian government agency.²⁷⁵

The case exemplifies the varied and complex problems faced by the parties to the suit and the court. Though some of the problems are limited to the particular and somewhat peculiar aspects of the Iranian revolution, the taking of American hostages and the U.S. response, the problems which this article addresses are relevant to most standby letter of credit transactions. Those problems discussed in Part II, which are relevant here are nonconformity of documentary demands, fraud in the transaction and its relationship to contract interpretation of the force majeure provisions, relationships between government entities in foreign countries, and indispensable parties in letter of credit disputes. In addition, the difference between defenses to suits for breach of contract based on impossibility, acts of state, and substantial performance, as opposed to affirmative assertions seeking injunctive relief from payments of standby letters of credit based on similar claims are important.

The district court's decision in the *Itek* case has been appealed to the First Circuit by both the defendants, First National Bank of Boston and Bank Melli Iran, and was argued orally in the First Circuit on December 9, 1982.²⁷⁶ Because of the appeal, the facts of the case and the analyses which follows are drawn from the briefs and affidavits of the three parties to the appeal and from the district court's opinion.²⁷⁷ The facts presented will be those pertinent to the merits of the case.²⁷⁸

A. *Statement of Facts*

In April 1977, Itek, an American corporation, entered into a contract with the Imperial Government of Iran for the manufacture of high-technology optical equipment

²⁷⁵ *Itek Corporation v. First National Bank of Boston*, No. 80-58 Slip opinion (D. Mass., May 25, 1982). This case will remain the only one in which a permanent injunction was granted of the district court level because the laws applicable to the Iranian litigation have changed.

²⁷⁶ *Itek Corporation v. First National Bank of Boston and Bank Melli Iran*, Nos. 82-1632, 82-1633 (1st Cir. March 29, 1983).

²⁷⁷ No. 80-58 Slip opinion (D. Mass. May 25, 1982); *Itek v. First National Bank of Boston*, 511 F. Supp. 1341 (D. Mass. 1981) (preliminary injunction granted); Brief for Appellant, *Bank Melli Itek Corporation v. First National Bank of Boston*, Nos. 82-1632, 82-1633 (1st Cir. 1982); Brief for Appellant, *First National Bank of Boston*, Nos. 82-1632, 82-1633 (1st Cir. 1982); Brief for Appellee, *Itek Corporation* Nos. 82-1632, 82-1633 (1st Cir. 1982).

²⁷⁸ The many procedural problems related to Executive orders, the Hostage Settlement Agreement, Treasury Regulations, and amendments to Treasury Regulations, will be omitted. Though the 1st Circuit based its decision to vacate the injunction on procedural aspects, it is necessary to approach the discussion in this way to avoid confusion and complex constitutional issues beyond the scope of this article.

at the agreed price of \$22,500,000.²⁷⁹ The contract required Itek to furnish the Imperial Government with four bank guarantees, each in the amount of \$1,125,000, issued by an Iranian bank naming the Ministry of War as beneficiary.²⁸⁰ The guarantees were intended to secure Itek's repayment of an advance payment by the Imperial Government of \$4,500,000 (twenty percent of the contract price), in the event of premature termination of the contract.²⁸¹ The contract also required Itek to furnish another bank guarantee in the amount of \$2,250,000, issued by an Iranian bank and naming the Ministry of War as beneficiary.²⁸² Its purpose was to secure Itek's good performance of its contractual obligations.²⁸³

Itek set up these guarantees through Bank Melli, a wholly owned instrumentality of the Imperial Government.²⁸⁴ Bank Melli agreed to the arrangement but required Itek to furnish standby letters of credit in Bank Melli's favor, issued by an American bank with terms and amounts identical to the guarantees issued by Bank Melli.²⁸⁵ Itek set up this back-to-back credit arrangement through the First National Bank of Boston (FNBB) by procuring five standby letters of credit, for the same amounts as the guarantees, each naming Bank Melli as beneficiary.²⁸⁶

The standby letters of credit issued by FNBB each required the following documents as a condition to their payment to Bank Melli: an authenticated cable stating that Bank Melli had been required by the Ministry of War to make payment under its corresponding guarantee and a notice that Bank Melli was airmailing to FNBB a signed statement that it had been required to pay.²⁸⁷

The standby letters of credit and guarantees issued in lieu of the advance payment made by the Imperial Government had extendable expiration dates and were to be discounted as Itek submitted invoices showing completed work under the contract.²⁸⁸ Thus, by the time Itek commenced this action on January 9, 1980, two of the four letters of credit had been discounted or expired, a third had been discounted to \$70,753, and the fourth remained \$1,125,000 for a total of \$1,195,753.²⁸⁹ These two advance payment letters of credit had extended expiration dates (allowed under the contract) of April 14 and 17, 1980.²⁹⁰

The standby letter of credit and its corresponding guarantee, issued as a good performance guarantee, were required to equal ten percent of the total contract price, \$2,250,000.²⁹¹ The standby letter of credit had an expiration date of February 15, 1981, but, under the contract, was required to remain in effect until four weeks after the last final acceptance.²⁹² The contract provided that final acceptance would occur one year after all equipment had been delivered, tested, and accepted.²⁹³ In other words, this

²⁷⁹ 511 F. Supp. at 1342.

²⁸⁰ *Id.*

²⁸¹ *Id.*

²⁸² 511 F. Supp. at 1343.

²⁸³ *Id.*

²⁸⁴ *Id.*

²⁸⁵ *Id.*

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ See 511 F. Supp. at 1343, n. 3.

²⁸⁹ *Id.*

²⁹⁰ *Id.*, Brief for Appellee at 9.

²⁹¹ 511 F. Supp. at 1343. Brief for Appellant, Bank Melli at 4.

²⁹² Brief for Appellee at 9, 11.

²⁹³ Brief for Appellant Bank Melli at 5.

standby letter of credit from the FNBB and its companion bank guarantee from Bank Melli were issued as a warranty that the goods would perform as expected and be of the quality required under the contract.

Provisions of the contract between Itek and the Imperial Government provided that in the event of force majeure, including the cancellation of the United States export license which would make shipment of the goods impossible, either party was entitled to inform the other that force majeure had occurred. After three months, the contract could be cancelled by written notice.²⁹⁴ The contract further provided that if the contract were cancelled, the parties would clear their account and release all guarantees and standby letters of credit.²⁹⁵

Once the contract was executed and all the guarantees and standby letters of credit were secured, Itek proceeded to perform its obligations under the contract.²⁹⁶ By February 10, 1979, Itek's performance was ahead of schedule, and the value of its work completed amounted to \$20,300,000.²⁹⁷ Of this amount, Itek had been paid \$11,100,000, including the \$4,500,000 of the down payment on which two of the advance payment letters of credit were still outstanding.²⁹⁸ During this time the Iranian revolution took place causing the downfall of the Imperial Government and the exile of the Shah.²⁹⁹ The successor to the Shah was Ayatollah Khomeini who abolished the Imperial Government and created the Islamic Republic of Iran.³⁰⁰ In addition, the Ministry of War (the original beneficiary under the guarantees) was abolished, and in its place, the Ministry of National Defense was created.³⁰¹

On April 30, 1979, the State Department cancelled the export license for the equipment produced under the contract between Itek and the Imperial Government. The cancellation allowed Itek to invoke the force majeure provisions of the contract which it first did on May 15, 1979.³⁰²

Following the seizure of the American Embassy in Iran on November 3, 1979, President Carter declared a national emergency and, by Executive Order Number 12170, blocked all Iranian assets.³⁰³ This began a lengthy and complicated progression of Executive Orders, Treasury Regulations implementing the orders, the Hostage Agreement, more Executive Orders, Treasury Regulations, and amendments to Treasury Regulations. All of these formed the core of FNBB's main argument that the judgment in the district court should be vacated because the Regulations had changed the applicable law.³⁰⁴ FNBB's main argument did not relate to standby letters of credit and, though worthy of academic discussion, is beyond the scope of this article.

On January 9, 1980, prior to any demand by Bank Melli for payment, Itek filed its complaint in this action against FNBB. The complaint sought injunctive relief against the payment by FNBB of any demand on all outstanding letters of credit related to the

²⁹⁴ Brief for Appellee at 10.

²⁹⁵ Brief for Appellee at 10, 11.

²⁹⁶ 511 F. Supp. at 1343.

²⁹⁷ *Id.*

²⁹⁸ *Id.*

²⁹⁹ *Id.*

³⁰⁰ *Id.*

³⁰¹ *Id.*

³⁰² *Id.*, Brief for Appellee at 11.

³⁰³ 511 F. Supp. at 1344.

³⁰⁴ Brief for Appellant, First National Bank of Boston, pgs. 20-49.

contract between Itek and the government of Iran.³⁰⁵ In its complaint, Itek claimed that it was highly likely that persons in Iran with access to relevant bank records would fraudulently demand payment from FNBB on the outstanding standby letters of credit.³⁰⁶ On the same day, the district court temporarily restrained the FNBB from honoring any demand without first giving Itek three days' notice.³⁰⁷ After a hearing, the district court issued a preliminary injunction to the same effect on January 18, 1980.³⁰⁸

In February and March of 1980, Bank Melli telexed to FNBB requesting extensions on the two outstanding letters of credit corresponding to Bank Melli's bank guarantees of the down payment.³⁰⁹ In the alternative, Bank Melli requested payment in full of the outstanding amounts.³¹⁰ Standing by themselves, these telexes might have been legitimate under the contract.³¹¹ However, because Itek already believed that the contract had been cancelled because of force majeure, and because they had informed the Ministry of Defense in May and December, 1979, after Itek had presented all invoices and a summary of the account to the Ministry, Itek refused to grant the extensions. Itek claimed that the letters of credit should have been released no later than four weeks after clearance of the down payment.³¹² Itek asserted that this occurred in August when they presented the Ministry of Defense with the unpaid invoices.³¹³ In addition, on March 7, 1980, Itek again sent written notice to the Ministry of Defense cancelling the contract and demanding release of all bank guarantees and letters of credit under the applicable provisions of the contract.³¹⁴

These events prompted Itek to amend its complaint showing the new developments and to ask again for temporary relief, which was granted on March 11, 1980.³¹⁵ The new restraining order enjoined FNBB from honoring any demand on the outstanding letters of credit.³¹⁶

On March 16, 1980, Bank Melli, by telex to FNBB, formally demanded payment of all outstanding letters of credit.³¹⁷ This is the demand later found by the district court to be nonconforming.³¹⁸ On March 19, 1980, Itek again amended its complaint adding Bank Melli as a defendant. Itek did not, however, name the Ministry of Defense as a defendant, the party which allegedly had fraudulently received payment under the guarantees issued by Bank Melli.³¹⁹

On April 10, 1981, the district court held that Itek was entitled to a preliminary injunction preventing the FNBB from honoring any demand under the letters of credit.³²⁰ On May 25, 1982, the same court issued its summary judgment opinion that the demands for payment under the letters of credit were nonconforming, that the demands

³⁰⁵ 511 F. Supp. at 1344.

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.*

³⁰⁹ *Id.*

³¹⁰ *Id.*

³¹¹ See Brief for Appellant Bank Melli at 5.

³¹² 511 F. Supp. at 1344, 1345.

³¹³ 511 F. Supp. at 1344.

³¹⁴ Brief for Appellee at 11, 12.

³¹⁵ 511 F. Supp. at 1345.

³¹⁶ *Id.*

³¹⁷ *Id.*

³¹⁸ No. 80-58, Slip Opinion at 6 (May 25, 1982).

³¹⁹ See Brief for Appellant, Bank Melli at 31-37.

³²⁰ 511 F. Supp. at 1352.

were accompanied by fraud in the transaction, that all three letters were without legal force and null and void, and that FNBB was permanently enjoined from honoring any demand.³²¹ The judgment was entered on June 1, 1982.

Following the district court's opinion, all post judgment motions made by Bank Melli and FNBB were denied, resulting in an appeal to the First Circuit by both Bank Melli and the FNBB on August 6, 1982. The decision by the First Circuit was handed down on March 29, 1983.³²² The appeals court vacated the district court's permanent injunction, but allowed reinstatement of the preliminary injunction.

B. Analysis of the Itek Case

1. Nonconformity of Demand

Because this case was argued in the First Circuit, Itek was forced to distinguish its case from the *Banco Espanol*³²³ and *Flagship Cruises*³²⁴ cases by showing that the demands made on the letters of credit did not even substantially conform to their requirements. Itek's task was particularly difficult due to amendments on the letter of credit requirements, the effects of which were disputed by the parties.³²⁵

The original conditions of the letters of credit required presentation of: (1) a draft accompanied by (2) Bank Melli's signed statement certifying that the amount of the draft represented funds they had been required to pay under their corresponding guarantees, and (3) a copy of the beneficiary's demand on Bank Melli's guarantee.³²⁶ A further condition of the letters of credit stated that they were available by Bank Melli's cable drawing on the FNBB, duly authenticated, mentioning the letter of credit number and stating that Bank Melli was mailing the required signed statement and a copy of the beneficiary's demand.³²⁷

Subsequent amendments to the letters of credit deleted the requirement of a draft and all references to a copy of the beneficiary's demand.³²⁸ Therefore, as both FNBB and Itek represented:

the letters of credit call[ed] for payment upon presentation of either (1) a signed statement certifying that the amount demanded represented funds which Bank Melli was required to pay to the beneficiary, or (2) a 'cable duly authenticated mentioning our letter of credit No . . . and stating that you are airmailing to us the required signed statement'.³²⁹

FNBB and Itek disputed the correct application of the amended requirements and the relationships to the doctrine of substantial compliance.³³⁰

³²¹ No. 80-58, Slip Opinion 10, 11 (May 25, 1982).

³²² *Itek Corporation v. First National Bank of Boston and Bank Melli*, Nos. 82-1631, 82-1632, 82-1633 Slip Opinion (1st Cir. March 29, 1983).

³²³ 385 F.2d 270 (1st Cir. 1967).

³²⁴ 569 F.2d 699 (1st Cir. 1978).

³²⁵ Brief for Appellee at p. 13, Brief for Appellant, First National Bank of Boston at 54.

³²⁶ Brief for Appellee at 13, Brief for Appellant, First National Bank of Boston, at 51.

³²⁷ *Id.*

³²⁸ Brief for Appellee at 13, Brief for Appellant, First National Bank of Boston at 52.

³²⁹ *Id.*

³³⁰ *See* Brief for Appellee at 13, 14; Brief for Appellant at 53-60.

In addition, FNBB contended that the district court added the requirement that Bank Melli state the amount which it had been required to pay, even though a draft was no longer required. The lack of a stated amount, which FNBB alleged was not required, was the primary reason for the district court's finding of nonconformity.³³¹

Though a close reading of the letter of credit requirements and amendments suggests that FNBB might have been correct, a close reading of the March 16 telex still creates sufficient confusion so that a bank or an appropriate court could find the demands nonconforming. Keeping in mind that the down payment letters of credit were to be discounted against invoices, the fact that the amounts of the letters of credit outstanding did not conform to the total amount requested should have been sufficient to justify a finding of nonconformity.³³² Were the bank to pay the total amount requested and then later find out that Iran had discounted a million dollars worth of invoices submitted by Itek prior to the demand, FNBB could have paid a million dollars in excess. FNBB would have incorrectly based its decision to pay the total amount on the assumption that the typographical accounting error was in the letters of credit and not the total amount. It would seem a wise move for any bank to demand clarification of a million dollar discrepancy in demands made on discountable letters of credit.³³³ A paying bank is no more required to know the specific amounts of down payment standbys discounted on the contract than it is required to look to the underlying contract to determine if the demand is legitimate.³³⁴ This conclusion supports the arguments made by Itek and adopted by the district court: that Bank Melli was required to state the exact amounts it had been required to pay.³³⁵ None of the parties, however, used the discrepancy in the telex as either a basis for an injunction, or as a discrepancy which, nevertheless, substantially complied with the terms of the letters of credit.³³⁶

The parties disputed the district court holding that the March 16 telex was nonconforming because of Melli's failure to state in the March 16 telex that it was airmailing the required signed statement.³³⁷ Bank Melli, in its brief to the First Circuit, referred the Appeals Court to FNBB's argument in its brief that the March 16 telex was, in fact, conforming.³³⁸ In addition, Bank Melli argued that its February and March telexes requesting extensions on the down payment standbys, or, in the alternative, payment of the outstanding amounts, were sufficient to require payment of the standbys.³³⁹ In support of this assertion, Bank Melli pointed to provisions in the letters of credit which state, "If this bank [FNBB] is unwilling to extend the validity of this letter of credit, then

³³¹ No. 80-58 Slip Opinion at 6 (D. Mass., May 25, 1982).

³³² The March 16 Telex in its entirety stated:

"Your credits S-14588, S-14559, S-14555, our guarantees 29369/D, 29370/D and 29366/D USLRS 70.753, USLRS 125,000 and USLRS 2.250,000 Beneficiaries have written claiming credits amount and we confirm that we have been required to pay under our guarantees stop pls therefore credit our Acc with our London Br with US DLRS 3.445.753 under teleadvice to us and our HO stop delay interest will accrue at 12% PA from date of claim until we receive reimbursement." Obviously, the total is one million dollars larger than the sum of the amounts quoted.

³³³ UCP, *supra* note 8, at Art. 8 (c).

³³⁴ See No. 80-58 Slip Op. at 6-8 (May 25, 1982).

³³⁵ No. 80-58 Slip Op. at 6 (D. Mass., May 25, 1982).

³³⁶ *But see* Brief for Appellee at 44, n. 12.

³³⁷ Brief for Appellee at 35-43, Brief for Appellant, Bank Melli at 16-19, Brief for Appellant, First National Bank of Boston, at 50-65.

³³⁸ Brief for Appellant, Bank Melli at 16.

³³⁹ Brief for Appellant, Bank Melli at 17, 18.

this bank [FNBB] will be committed to remit the amount of this letter of credit without further demand on the part of Bank Melli, Iran."³⁴⁰

Itek argued that, though this provision is stated accurately, after Bank Melli requested the extensions, FNBB did not refuse to extend but merely telexed Bank Melli that Itek considered the underlying contract to be terminated, and that Itek requested Bank Melli to withdraw its request for extension.³⁴¹ Itek alleged that FNBB was merely seeking advice as to what to do next under the circumstances.³⁴² Bank Melli responded with the March 16 telex which demanded payment based on the claim that it had been required to pay under its corresponding guarantees.³⁴³ Itek was thus saying that Bank Melli could have insisted that FNBB extend the letters of credit, but instead, made a nonconforming demand in the form of the March 16 telex which failed to state that Bank Melli was mailing to FNBB the required signed statement.³⁴⁴

FNBB argued that the words of the telex substantially conformed to the letter of credit requirements, and that the amendments made "the signed statement [serve] no purpose which could not equally well be served by the authenticated telex."³⁴⁵ FNBB maintained that the telex supplied the substance of what was required to be in the signed statement anyway.³⁴⁶

Itek, of course, claimed that such an assertion was a long way from substantial compliance with the terms of a letter of credit.³⁴⁷ Itek cited a long line of cases which held that where documents are missing, the demand is nonconforming. Itek then made the leap necessary in standby letters of credit, alleging that, "[i]n logic, the same proposition is obviously true when a demand is required to contain several representations, but one is omitted. We are not aware of any case holding to the contrary."³⁴⁸

Following this conclusory assertion, Itek attempted to show that in this case, *Banco Espagnol*³⁴⁹ and *Flagship Cruises*³⁵⁰ require a finding of nonconformity. In *Banco Espagnol*, the court found that all the documents required were present, but due to confusion created by the bank's customer, the language of the inspection certificate did not match *in haec verba* the language required in the letter of credit.³⁵¹ Itek suggested that, "[t]he court's reasoning cannot be twisted to support a conclusion that the complete failure to comply with a plain and clear requirement of a letter of credit constitutes a conforming demand."³⁵²

Flagship Cruises held that the statement as given was the "functional equivalent"³⁵³ of the letter of credit requirement. Itek submitted "that the complete failure to provide the

³⁴⁰ *Id.*

³⁴¹ Brief for Appellee, at 45.

³⁴² Brief for Appellee at 46; Itek also notes that Bank Melli's claim that the February 18 and March 4 telexes were conforming demands is being raised for the first time on appeal and that, therefore, Bank Melli is precluded from raising it now. *Johnson v. Holiday Inns, Inc.*, 595 F.2d 890 (1st Cir. 1979); *Dobb v. Baker*, 505 F.2d 1041 (1st Cir. 1974).

³⁴³ Brief for Appellee at 46.

³⁴⁴ No. 80-58 Slip Op. at 8 (D. Mass., May 25, 1982).

³⁴⁵ Brief for Appellant, First National Bank of Boston, at 56.

³⁴⁶ *Id.*

³⁴⁷ Brief for Appellee at 37.

³⁴⁸ Brief for Appellee at 38.

³⁴⁹ 385 F.2d 230 (1st Cir. 1967).

³⁵⁰ 509 F.2d 699 (1st Cir. 1978).

³⁵¹ 385 F.2d at 237.

³⁵² Brief for Appellee at 39.

³⁵³ 569 F.2d at 703.

signed statement would have compelled a different result in the *Flagship Cruises* case and compels the conclusion in Itek's case that the March 16 telex was nonconforming."³⁵⁴

The structural and functional differences between standbys and traditional letters of credit create the main flaws in Itek's argument. The weak link in the argument is the leap from missing documents required in a letter of credit causing nonconformity, to missing representations in the document required in a standby letter of credit creating nonconformity.

Both FNBB and Bank Melli argued that the March 16 telex and the required signed statement, dated April 14, 1980, but not received by FNBB until May 27, 1980, amounted to a conforming demand for the good performance standby, since it did not expire until 1981.³⁵⁵ The district court held that the telex and the signed statement were nonconforming because they failed to specify that the amount demanded represented funds that Bank Melli had been required to pay.³⁵⁶ It is true, however, as Bank Melli points out, that Article 8(e) of the UCP placed on FNBB the obligation to inform Bank Melli of any nonconformity in the demand "without delay."³⁵⁷ This FNBB did not do, so Bank Melli was correct on this particular claim.

Thus, had the circuit court ever reached the merits of this case, as to nonconformity of documentary demands, they should have concluded, even against their own doctrine of substantial compliance, that Bank Melli was not entitled to payment of the down payment letters of credit because, (1) it did not state how much it had been required to pay under its guarantees to the beneficiary,³⁵⁸ (2) its own telex's numbers did not add up correctly,³⁵⁹ (3) it failed to state that it was mailing the required signed statement,³⁶⁰ and (4) that problem was not cured by the arrival of the statement because it did not arrive until after the expiration of the down payment letters of credit.³⁶¹ The only hitch would have been that the court could have found that the letters should have been paid the instant FNBB notified Bank Melli that no extensions would be made.³⁶² By their terms, albeit not very good ones for Itek, the letters of credit required payment without further demand should FNBB state that no extensions would be made.

With respect to nonconformity on the good performance standby, FNBB should have notified Bank Melli of any problems with the demand, and there was ample time to do so prior to expiration of the credit.³⁶³ All this, of course, assumes that Itek's arguments regarding fraud and the cancellation of the underlying contract had no merit.

2. Fraud in the Itek case

Until Bank Melli made demands on the letters of credit, Itek's claims of fraud based on UCC § 5-114, like those of many of the account parties, were purely speculative, and merited no more than the notice injunction granted to many banks' customers.³⁶⁴ But

³⁵⁴ Brief for Appellee at 40.

³⁵⁵ Brief for Appellant, Bank Melli at 19, Brief for Appellant, First National Bank of Boston at 55.

³⁵⁶ No. 80-58 Slip Op. at 8 (D. Mass., May 25, 1982).

³⁵⁷ Brief for Appellant, Bank Melli at 19.

³⁵⁸ See text accompanying notes 323-331.

³⁵⁹ See notes 331-336 and accompanying text.

³⁶⁰ See notes 337-340 and accompanying text.

³⁶¹ See notes 309-318 and accompanying text.

³⁶² See notes 337-340 and accompanying text.

³⁶³ Brief for Appellant, Bank Melli at 19.

³⁶⁴ See note 233, *supra*.

once the demand was made, the potential for irreparable harm was established, and the district court was willing to look at aspects of the underlying contract to determine the validity of Itek's claims.³⁶⁵

In its arguments based on fraud in the transaction, Itek needed to show the court that its allegations were not simply disputes on the contract between itself and the beneficiary as to whether or not Iran had the right to demand payment. Itek needed to show that the demands on the letters of credit by Iran and the Bank were knowingly fraudulent, to the extent that they rose above mere disputes on the contract and tainted the whole transaction with fraud.³⁶⁶ If the parties had agreed that contract disputes would be litigated in United States' courts rather than in Iranian courts as the contract required, Itek's task would have been considerably easier. This is because the contract clearly states the procedure which had to be followed in the event of force majeure.³⁶⁷

Though force majeure does not usually include a right to be invoked if an export license is cancelled, the parties in this case specifically agreed that if the export license for the goods produced were cancelled, Itek would be required to inform the other parties and make plans to consult and exchange views as to what to do about the problem.³⁶⁸ The contract continued to require that "if within three (3) months from the date of requesting for negotiations by either party, a mutually agreeable solution is not found, each party can on his opinion, cancel the Contract by giving written notice to the other party."³⁶⁹

In August 1979, after the U.S. government had voided the application for renewal of the export license, a representative from Itek went to Iran and presented the officials there with all outstanding invoices with the intention of "clearing the accounts."³⁷⁰ In November, Itek again was refused renewal of the export license.³⁷¹ In December, Itek informed Iran again of cancellation of the contract due to force majeure as defined in the contract.³⁷²

The contract further provided for the release of the down payment standbys within four weeks after the clearance of the downpayment amounts.³⁷³ It also stated that in the event the contracts were cancelled due to force majeure, all good performance guarantees should be released immediately.³⁷⁴ On March 7, 1980, having followed the contract provisions to the letter, Itek sent notice formally cancelling the contract.³⁷⁵ Bank Melli responded by making a demand on the letters of credit, claiming that it had been required to pay on its corresponding guarantees.³⁷⁶

Noting that the UCC does not define fraud in the transaction and emphasizing that the flexible standard should be applied, Itek alleged that the call on the letters of credit fell squarely within the ambit of the court's decision in the *Dynamics* case.³⁷⁷ Itek believed that Iran was trying to take unconscientious advantage of the demand requirements and

³⁶⁵ No. 80-58 Slip Op. at 8 (D. Mass., May 25, 1982).

³⁶⁶ Brief for Appellee at 30.

³⁶⁷ See Brief for Appellee at 10-12.

³⁶⁸ Brief for Appellee at 24.

³⁶⁹ *Id.*

³⁷⁰ Brief for Appellee at 25.

³⁷¹ *Id.*

³⁷² *Id.*

³⁷³ *Id.*

³⁷⁴ Brief for Appellee at 26.

³⁷⁵ *Id.*

³⁷⁶ *Id.*

³⁷⁷ Brief for Appellee at 28.

abscond with Itek's money on a pro forma declaration which had absolutely no basis in fact.³⁷⁸

Though FNBB did not rebut Itek's fraud arguments, Bank Melli asserted that, not only was there no fraud, but that the facts Itek asserted in support of its contention of fraud were nothing more than potential defenses to a suit for breach of contract against Itek for its failure to deliver the goods. Bank Melli argued that the issues must be resolved in contract litigation between Itek and the Ministry of Defense.³⁷⁹ Bank Melli even went so far as to suggest that the fraud may have been on Itek's part alleging intentional failure to ship any goods, intentional repudiation with evil intent, and deliberate abandonment and destruction of the underlying contract (phrases drawn from letter of credit cases).³⁸⁰

Bank Melli hotly contested Itek's and the district court's conclusions that the export license was ever cancelled.³⁸¹ The Bank asserted that the export license was merely suspended, a term which Bank Melli said has a temporary connotation.³⁸² Bank Melli pointed to the relevant regulations which provide that the State Department may only deny, revoke, or suspend an export license.³⁸³ Itek, on the other hand, asserted that the cancellation argument was being raised for the first time on appeal and should not be considered by the circuit court because it was not raised below.³⁸⁴ Itek also noted that, in any event, the necessary renewal application for export was voided, and the U.S. government refused to grant a continuation of the license, thus making it impossible to ship the goods no matter how Bank Melli might interpret the force majeure provisions of the contract.³⁸⁵

Perhaps the most persuasive argument advanced by Bank Melli was that, by requesting only extensions, or in the alternative, payment if extensions were denied, the Ministry of Defense was acting:

in a commercially reasonable manner, befitting a party concerned about Itek's failure to ship but willing to give Itek more time so long as Itek agreed to keep its security in place until it had completed performance. This was precisely what the contract and letters of credit themselves envisioned. The FNBB letters required FNBB to either extend or pay; there was no third alternative. Itek bargained over and agreed to these terms; it cannot now evade them.³⁸⁶

In further asserting the lack of fraud on Iran's part, Bank Melli incorrectly concluded that "fraud in the transaction" was a doctrine first developed in *Sztejn*, and then asserted that "anything short of *Sztejn*-like chicanery is not "fraud in the transaction."³⁸⁷ Because *Sztejn* does not stand for the doctrine of "fraud in the transaction," but instead established that forged or fraudulent documents may justify an injunction,³⁸⁸ Bank Melli's reasoning is incorrect. This is true despite the *American Bell* decision in which the court denied a preliminary injunction with reasoning similar to the above, holding that

³⁷⁸ *Id.*

³⁷⁹ Brief for Appellant, Bank Melli at 20.

³⁸⁰ Brief for Appellant, Bank Melli at 29.

³⁸¹ Brief for Appellant, Bank Melli at 22.

³⁸² Brief for Appellant, Bank Melli at 21.

³⁸³ Brief for Appellant, Bank Melli at 23.

³⁸⁴ Brief for Appellee at 29.

³⁸⁵ Brief for Appellee at 30.

³⁸⁶ Brief for Appellant, Bank Melli at 26.

³⁸⁷ Brief for Appellant, Bank Melli at 27.

the "plaintiff is still far from demonstrating the kind of evil intent necessary to support a claim of fraud."³⁸⁹

The difficulty faced by the courts is to decide where to let the axe fall in close cases such as this, where the availability of facts is limited and case precedents appear to support either side. The dividing line in this case is clearly the difference between the contract disputes, and fraudulently calling on the standbys. Because the allegations of fraud are so connected to the provisions of the contract on force majeure, the court faced what appears to be an irreconcilable dilemma.³⁹⁰ But as suggested in Part II, if the circuit court had found that the disputes were on the contract, then Itek's only recourse would have been in the Iranian court system where the tribunals are likely to be less than sympathetic to the grievances of an American company against the government of Iran.

As a final consideration in this force majeure, fraud discussion, it should be noted that the force majeure provisions were so specifically and uniquely worded that they showed the intent of, and the procedures to be used by the original parties to the contract should the export license get cancelled; this occurred long before any of the political developments in Iran.³⁹¹ It should naturally follow that a court would seriously consider the parties' obligations in such a situation in order to determine who had adhered most closely to the contract requirements, and who perhaps had disregarded them in an illegitimate, if not fraudulent attempt to grab a few million dollars.³⁹² Though the courts may not adjudicate disputes on the contract,³⁹³ they do have an equitable power to determine if there has, in fact, been fraud.³⁹⁴ Bank Melli seemed to argue the case as if the standbys represented liquidated damages in the event of cancellation or in the likelihood that the goods never arrived. In fact, Bank Melli framed its arguments around the assertion that Itek was able to keep all the goods and sought, in addition to the \$11,000,000 already paid, another \$9,200,000 which represented the work completed but not delivered, and cancellation of all standby letters of credit, including its good performance guarantee.³⁹⁵ Though the government of Iran certainly seemed to have had the bargaining power to insist on liquidated damages standbys when it made the deal, the contract contains no such provision. Any allegations to the contrary are illusory attempts to justify payments on the standbys.

3. Holder in Due Course Status and the Relationships Between Iranian Government Entities

Both the *Cambridge*³⁹⁶ and *Banco Espagnol*³⁹⁷ cases held that where the defense of fraud is established, the burden shifts to the bank to prove that it was a holder in due

³⁸⁸ See note 172 and accompanying text.

³⁸⁹ 474 F. Supp. at 425.

³⁹⁰ One particular difficulty with the Itek case is the lack of facts. That the District Court could decide there had been fraud in the transaction based only on allegations and evidence submitted by Itek, even though it was Bank Melli's own fault for not alleging its own set of facts, takes some of the punch out of the court's conclusion.

³⁹¹ Brief for Appellee at 31.

³⁹² No. 80-58 slip op. at 8, 9 (D. Mass., May 25, 1982).

³⁹³ *Id.*

³⁹⁴ *Id.*

³⁹⁵ Brief for Appellant Bank Melli at 10.

³⁹⁶ 41 N.Y.2d 254, 392 N.Y.S.2d 265, 360 N.E.2d 943 (1976).

³⁹⁷ 385 F.2d 230.

course — one which had taken the drafts or demands for value, in good faith, and without notice of expiration or any other defenses or claims.³⁹⁸

Bank Melli placed itself in a difficult position by presenting no proof that it was entitled to holder in due course status in its arguments to the district court.³⁹⁹ As Itek pointed out in its First Circuit brief, Bank Melli received the telex from FNBB advising it that Itek believed that underlying contract to be terminated, and that a court had restricted payment. Bank Melli was therefore on notice of Itek's claims and defenses, including notice of fraud.

The district court found additionally that Bank Melli made "no showing, nor offered any evidence to show that it had no notice of the underlying fraud and that it paid value."⁴⁰⁰ The court concluded, as did several others in Iranian cases, that it was "fanciful, unrealistic, and unnecessary"⁴⁰¹ to treat the bank and the government of Iran as separate and independent entities.

Rather than asserting that it was a holder in due course as required by both *Banco Espagnol*⁴⁰² and *Cambridge*,⁴⁰³ Bank Melli asserted that it could not not be a holder in due course, a claim which does not go far enough to meet the burden of proof shifted to Bank Melli by the holdings of the above cases. It is true that a double negative in both mathematics and plain English creates a positive; however, on this particular point in letter of credit law it creates a grey area in which the burden remains on the claimant to prove his assertion.

4. Indispensable Parties

As noted earlier in Part II.B.2.h., in most of the Iranian cases, the party who was most likely to perpetrate the fraud, the beneficiary sovereign agency, was seldom, if ever, a party to the suits for injunctions.⁴⁰⁴ Bank Melli, under Rule 19(a) of the FRCP,⁴⁰⁵ attempted to convince the court that the Ministry of Defense should have been joined as an indispensable party to the case because a decision going against Bank Melli would subject it to a substantial risk of inconsistent obligations.⁴⁰⁶ Though Bank Melli did not specify what the inconsistent obligations might be, Itek suggested that it was probably Bank Melli's concern that it may never be reimbursed for payments made on its guarantees.⁴⁰⁷ Citing several cases, Itek maintained that this is not sufficient.⁴⁰⁸ It stated that the inconsistent obligations occur where the party might be subject to two judgments with which the party cannot comply.⁴⁰⁹ Bank Melli also argued that without the Ministry of Defense as a party, Bank Melli could not fairly defend itself against Itek. Any judgment enjoining FNBB from making payment to Bank Melli relied on a finding that the Ministry of Defense had committed fraud.⁴¹⁰

³⁹⁸ 41 N.Y.2d at 262, 392 N.Y.S.2d at 272, 360 N.E.2d at 950.

³⁹⁹ No. 80-58 Slip op. at 9 (D. Mass., May 25, 1982).

⁴⁰⁰ No. 80-58 Slip op. at 9 (D. Mass., May 25, 1982).

⁴⁰¹ No. 80-58 Slip op. at 5 (D. Mass., May 25, 1982).

⁴⁰² 385 F.2d 230.

⁴⁰³ 41 N.Y.2d 254, 392 N.Y.S.2d 265, 360 N.E.2d 943 (1976).

⁴⁰⁴ See notes 268-269 and accompanying text.

⁴⁰⁵ FED. R. Civ. P. 19(a).

⁴⁰⁶ Brief for Appellant, Bank Melli at 36.

⁴⁰⁷ Brief for Appellee at 56.

⁴⁰⁸ Brief for Appellee at 57.

⁴⁰⁹ *Id.*

⁴¹⁰ Brief for Appellant Bank Melli at 36.

The district court rejected Bank Melli's contention that the Ministry of Defense was an indispensable party, and cited to the *KMW*⁴¹¹ case for the proposition that cases involving letter of credit litigation do not require that all parties to the underlying contract be joined. The court also recognized the unity of the Islamic Republic, its banks, and its agencies, and chose to view them as one.⁴¹²

Perhaps most importantly, Itek noted that the Ministry of Defense's ability to protect any interests it may have had were not impeded. Unless Bank Melli's demand was fraudulent, it had already paid on its guarantees to the Ministry.⁴¹³ Additionally, because the Ministry was not a party, the judgment would not bind it in any other litigation.⁴¹⁴ It would have been very surprising if the First Circuit held differently on appeal. The Ministry allegedly had been paid and no judgment in a U.S. court would change that fact.

Whether the Ministry of War was an indispensable party to the case was the only issue relevant to letter of credit cases on which the First Circuit issued a ruling. The court held that the Ministry of War was not an indispensable party. It also reasoned that, "[e]ven if, as Bank Melli claims, Bank Melli and the Ministry of War are separate and independent entities, a judgment in this case will not prejudice Bank Melli's efforts to obtain reimbursement from the Ministry of War for funds paid on the letters of credit, nor will the Ministry of War be bound by a judgment in this case on the merits of the 'fraud' issue."⁴¹⁵

IV. METHODS FOR ADAPTING LETTERS OF CREDIT TO THEIR PROPOSED USES

There are many lessons to be learned from the cases discussed in this article. This part adopts a somewhat unusual approach for bringing letters of credit in line with the laws governing them. Most commentators agree that standby letters of credit are different in both function and form from traditional letters of credit.⁴¹⁶ Although most agree that changes are needed, either by adapting the letters and their new uses to the law, or changing the law to reflect the new uses, few commentators are in complete agreement as to what should be done.

At one time, letters of credit were simply letters issued by a bank at the request of one of the bank's good customers for the benefit of someone else, which allowed the beneficiary to draw up to the stipulated amount on his demand. As their commercial use expanded, the documentary standard was introduced creating a check on the beneficiary's power to demand the money; he needed first to have the required documents in order to make a legitimate demand for the money held for his benefit. As international commercial activity grew to major proportions, the transactions became more complicated. Though the basic relationships between the principal parties to a letter of credit remain the same — customer, issuer, beneficiary — the number of potential parties to a letter of credit has greatly expanded.

In the banking system, there are now obligor banks — the issuing banks and confirming banks, and neutral party banks — advising banks, paying banks, negotiating banks, and corresponding banks.⁴¹⁷ Parties to the underlying contract and the letters of

⁴¹¹ 606 F.2d 10.

⁴¹² No. 80-58 Slip op. at 4 (D. Mass., May 25, 1982).

⁴¹³ Brief for Appellee at 56.

⁴¹⁴ *Id.*, Brief for Appellant, Bank Melli at 36.

⁴¹⁵ No. 82-1631 Slip op. at 25 (1st Cir., March 29, 1983).

⁴¹⁶ See generally articles cited, n. 220 *supra*; Note, *Guaranty Letters of Credit: Problems and Possibilities* [hereinafter cited as *Problems and Possibilities*], 16 ARIZ. L. REV. 822 (1974), Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C.L.J. 7 (1971).

⁴¹⁷ See generally HARFIELD, LETTERS OF CREDIT, Uniform Commercial Code/Practice Handbook. ALI/ABA (1971).

credit can include the bank's customer, a trustee in bankruptcy, the other party to the contract, the beneficiary, who may be nothing more than the entity with the right to payment under the letters of credit, and the third party issuer of documents required by the letter of credit.⁴¹⁸ The confusion, problems, and occasional injustices which can result from so many different parties to a contract involving letters of credit should be apparent from the cases discussed in this article. Many commentators in the wake of the Iranian cases have advocated legislation or judicially created doctrines which would recognize the different types of letters of credit.⁴¹⁹

This article argues that the power to adapt the new uses of letters of credit to the controlling law is in the hands of the principal parties to the letter of credit — the bank, the bank's customer, and the contracting party-beneficiary. Not only is this a simpler and more flexible approach to letters of credit than legislation or judicially created doctrines, it is allowed under both the UCC and UCP. A basic reading of Article 5 of the UCC reveals that phrase, "[u]nless otherwise agreed" no less than fifteen times within the Code's provisions.⁴²⁰ Additionally, the Code in general adheres to the principles of freedom of contract allowing the parties to bargain for their individual interests.⁴²¹ Though the UCP discourages excessive detail in letter of credit contracts in order to guard against confusion,⁴²² it does advocate clear instructions on the terms of the letters so that the parties' intentions are clear, and the documentary standard applicable.⁴²³

This is not to say that the use of letters of credit should continue unchanged. On the contrary this Part argues that the banks have the power to tighten up standards for letters of credit to protect themselves and their clients. This is well worthwhile since the banks are now exposed to more flexible standards for fraud and shifted burdens of proof for holder in due course status, thus subjecting them to greater risks of litigation despite the banks being the most innocent party to the whole transaction. The remainder of this article will recommend measures which the banks should take when issuing letters of credit. Such recommendations will take into account the use to which a letter of credit is put and reflect the risks undertaken by the parties to it. It is, after all, the banks who deal in these types of transactions as part of their business.⁴²⁴ The banks' position not only suggests that the banks should advise their clients on proper form for a particular type of letter of credit, but also empowers them to raise elemental standards in order to protect their own business interests. In three separate sections, this Part will recommend, first, procedures banks should take to protect their own business interests and to bring all types of letters of credit into line with applicable law, second, terms a bank should suggest to its customer, and third, terms a bank or a lawyer can recommend to a client who is a beneficiary under a letter of credit.

A. For the Banks

Industry practice has been to require few documents in letters of credit, especially when standbys are involved. The courts have therefore been required to stretch the documentary standard so that it can be applied to cases involving standbys in which no

⁴¹⁸ See generally, cases cited and discussed in this article.

⁴¹⁹ See note 220, *supra*.

⁴²⁰ UCC *supra* note 8 at Article 5, Letters of Credit. See also *Problems and Possibilities*, *supra* n. 416 at p. 834, n. 77.

⁴²¹ Cf. U.C.C. § 5-102, Comment 2, UCC 1-102 *supra* note 8.

⁴²² See UCP *supra* note 8 at General Provision (d).

⁴²³ See UCP *supra* note 8 at General Provision (b).

⁴²⁴ But see UCC § 5-102(1)(b), *supra* note 8.

third party documents are required, or where the beneficiary itself issues the documentary demand requiring payment.⁴²⁵

For their own protection banks should require a minimum amount of documents or specific types of documents which would be adequate to determine whether a proper demand has been made.⁴²⁶ For example, for a good performance standby, the bank could require that there be specific facts alleged in particular documents which demonstrate nonperformance. Such a bank-mandated requirement is particularly recommended when standbys are involved because, with no collateral involved, the risks are far greater and the possibility of recoupment for improper payment less likely. Clearly, this is safer for everybody; such a requirement acts only to make it more difficult for a beneficiary to make a fraudulent demand.

An issuing bank should insist on specific wording of demands, and always require a draft stating the specific amount to be drawn under a letter of credit.⁴²⁷ This would not only help to insure that it is the correct party making the demand, but would also tend to avoid problems created by parties using vague local terms, lacking in specificity and easily discernible meaning. For example, banks, by requiring specific wording, would not need to determine the actual meaning of a phrase such as, "We anticipate that you will pay this demand." Though one cannot be sure of its meaning, the phrase means something much less than, "We require payment immediately."

Specific facts or occurrences should be noted in standbys. This would enable a bank's customer to gather proof that such a fact does not exist or that such an event has not occurred to justify payment.⁴²⁸ They would also give the beneficiary the security of knowing exactly what would justify payment. If the obligations and rights of the parties to a letter of credit are explicitly stated, confusion and misunderstanding would be substantially reduced, resulting in less litigation and expenses for all parties. The main point here is not to reduce the abilities of the customer and beneficiary to bargain for and amend terms of a letter of credit, but to ensure that a minimum number of requirements would be present in a particular type of letter of credit. These requirements would reflect the purpose for which the letter was issued. The primary purpose behind the minimum requirements is to ensure that the banks will avoid losses which would benefit the beneficiary, or possibly the bank's customer, who is responsible for having the letter of credit issued in the first place.

Further protection against an issuing bank suffering any loss as a result of a court injunction against reimbursement would be a requirement of indemnification from a bank's customer in any circumstance short of bank fraud.⁴²⁹ If a confirming bank is involved, it should also try to get indemnification from the issuing bank's customer so that if the issuing bank refused to reimburse a confirming bank which had paid, the customer

⁴²⁵ See notes 325-363 and accompanying text.

⁴²⁶ With the many uses for letters of credit, the documents will vary; but as a use is suggested, it would take little time to make a preliminary investigation and find an appropriate document or develop one for a particular use.

⁴²⁷ To require a draft seems so elementary in a letter of credit transaction; banks should never allow customers to amend a letter of credit so that one is not required. It is a document for the bank, not the customer, and should not be considered a bargaining chip at all.

⁴²⁸ Under both the UCP and UCC, the bank's customer will have a minimal amount of time to gather facts which will be sufficient to justify an injunction. Thus, the more clearly the situation which will justify payment is expressed, the easier it will be to gather proof.

⁴²⁹ See UCC § 5-109.

would still be liable for payment if, for example, the documents did not conform.⁴³⁰ If the documents did not conform, the issuing bank's customer would have to show fraud prior to the confirming bank accepting the documentary demand and making payment under the letter of credit or guarantee. In turn, for the protection of the bank's customer, any such indemnification clause should require notice to the customer of receipt of conforming demands, and allow a three-day grace period. This three-day grace period is similar to the notice injunctions granted in some of the Iranian cases, and allows the customer to gather enough proof showing that the demand was fraudulent.⁴³¹ The law is not clear on the obligations and rights of the parties if a customer attempts to enjoin the bank after it has accepted the documents, but before it has paid.

These recommendations merely reflect the need for banks to accommodate their practices to the new uses of letters of credit in order to protect themselves and their clients. Because United States legislation and any judicially constructed doctrine would not affect any foreign banks unless they subjected themselves to jurisdiction, it makes more sense to place on the banks the obligation to set higher standards in certain types of letters of credit. Major change is not recommended, but important adjustments are needed so that the letter of credit mechanism can survive and adapt as new situations and uses mandate.

B. *For the Bank's Customer*

Because the bank issues letters of credit, the bank is the party which should be the best informed about options on terms of letters of credit which will benefit its client. In most cases, the following recommendations benefit the bank as well as the customer because they clarify the rights and obligations of all the parties, making it easier for the bank to perform its obligations with efficiency and confidence.

1. Third Party Issuers of Documents

In any type of letter of credit transaction, the presence of a third party, which would also issue documents required by the terms of a credit, helps to protect the customer against arbitrary or fraudulent demands by the beneficiary.⁴³² Though not a new idea in the area of traditional letters of credit, third parties are seldom if ever used in standby letter of credit transactions, which by their nature, subject the customer to greater risks. In a letter of credit transaction involving a sovereign beneficiary, the third party issuer of documents creates a buffer zone which makes it more difficult for the beneficiary to make an arbitrary demand. If it can also be shown that the third party was involved in a fraud with a sovereign beneficiary, the customer would have a non-sovereign defendant to sue for damages. This avoids the difficulty of subjecting a foreign sovereign to the jurisdiction of a domestic court.⁴³³

⁴³⁰ UCC § 5-107 suggests that the confirming bank acquires the rights to the issuing bank anyway. There is no provision against a confirming bank requiring indemnification from the customer.

⁴³¹ See UCC § 5-112 (allows bank to withhold honor of a demand for three banking days), *supra* note 8.

⁴³² *Problems and Possibilities*, *supra* note 416 at 847, *Remedies of the Account Party*, *supra*, note 220 at 379, *Reflections After Iran*, *supra*, note 220 at 500.

⁴³³ *Remedies of the Account Party*, *supra*, note 220 at 379.

2. Strict Construction Clauses

To avoid different judicial decisions on the compliance of documentary demands with the terms of a letter of credit, the customer should attempt to include a strict construction clause in the letter of credit contract.⁴³⁴ Combined with specific terms and wording required by the banks,⁴³⁵ such a clause would make it easy for a bank or court to determine if a demand was conforming. This eliminates the need to construe past cases to determine compliance.

3. Immediate Deductibility of Downpayment Letters of Credit

As in *Itek* where the seller has had standbys issued against down payments by the buyer, the customer should attempt to set up the standbys to provide for his own issuing of documents in the form of invoices evidencing work completed. If the buyer is concerned about the customer fraudulently issuing invoices the parties could agree to a third party certification of the invoices. Such an approach would also help to uphold the documentary standard of letters of credit.

4. Force Majeure Clauses in the Underlying Contract

Improper calls on letters of credit could be avoided by the use of a well defined force majeure clause. Clear procedures should be established regarding the status of an outstanding letter of credit in the event that force majeure occurred. Though the force majeure clause in the *Itek* case did not completely protect Itek, it was a major factor in the district court's determination that fraud in the transaction had occurred.⁴³⁶ A properly worded force majeure clause would greatly help to demonstrate the intentions of the parties to the underlying contract and their intentions regarding outstanding letters of credit.⁴³⁷

5. Keeping the Number of Banks Involved to a Minimum

A bank's customer is always better off when the number of banks involved in a letter of credit transaction is kept to a minimum. In the arrangements used in the Iranian cases, Bank Mellis was in a position to make a conforming demand on the guarantee and collect payment from the confirming government bank without the customer in the United States even knowing it. In the Iranian cases, the courts often viewed the sovereign beneficiary and the government bank as united entities controlled by the Islamic Republic.⁴³⁸ Nevertheless, the courts may not always make such a finding. In such a case, a foreign bank which has honored the credit demand would probably be found to be a holder in due course. The issuing bank would then be committed to pay, and the bank's customer would have to reimburse the bank.

⁴³⁴ This will clearly help in any litigation since courts are bound by the agreements of the parties regardless of how the court may construe the conformity doctrines.

⁴³⁵ See notes 23-85 and accompanying text.

⁴³⁶ No. 80-58 Slip op. at 10 (D. Mass., May 25, 1982).

⁴³⁷ Even though the *Itek* contract with Iran appeared to prescribe detailed procedures in the event of force majeure, when it came down to the word "cancel" on the export license, the parties learned that the State Department only "suspended, revoked, or denied" licenses, thus triggering the dispute. See Brief for Appellant, Bank Mellis at 23, Brief for Appellee at 30.

⁴³⁸ No. 80-58 Slip op. at 4 (D. Mass., May 25, 1982).

The best arrangement would be to have an American issuing bank in the U.S. with a branch in the foreign country of the beneficiary. The branch could either be an advising bank, a correspondent bank, or a second-tier guarantor which issues a guarantee. An arrangement involving a second-tier guarantor would allow the foreign branch to look to elements of the underlying contract to determine the legitimacy of the demand.⁴³⁹

Because nonconformity does not apply to holder in due course status (meaning that a bank which pays against nonconforming documents is not protected from liability) banks also benefit when fewer banks are involved. Thus, both banks and customers should work towards this goal.

6. Maintaining the Proper Sovereign Beneficiary

The doctrine of state succession allows the sovereign beneficiary to change without recourse from the letter of credit doctrine of strict conformity. It is therefore to the customer's benefit to have an individual beneficiary named in the letter of credit, as opposed to a government or one of its agencies. Additionally, a clause requiring immediate release of a letter of credit if the government of a country is overthrown by force of arms or a coup d'etat would protect a customer against a successor regime which perhaps neither likes nor wishes to continue to deal with customers from a particular country, and would not mind adding some standby money to its coffers.

7. Modifying Boiler Plate Letters of Credit

As noted in the introduction to this section, the UCC Article 5 provisions often begin with the phrase, "[u]nless otherwise agreed. . . ."⁴⁴⁰ Prior to the Iranian letter of credit litigation, it was not uncommon for standby letters of credit to be issued in a standard form. Often the only negotiated aspect would be the percentage which the bank's customer would pay the issuing bank for the service. As the results of the Iranian cases suggest, this should no longer be the only element of a letter of credit negotiated. Those who initially drafted the letter of credit statutes may not have realized that the uses of letters of credit as a versatile and useful financial instrument would expand so greatly; but perhaps as a recognition of the principle of freedom of contract, they made sure that such diversification would be possible. It is now up to the banks, the customers and the beneficiaries to take advantage of that which has always been available to them. The legislature has already acted; and there should be no need for the judiciary to restrict the uses of letters of credit.

C. For the Beneficiary

The beneficiary's primary interest is to be able to receive payment upon demand. As a result, it must use its bargaining power to keep the customer from including all the clauses and ideas recommended above from incorporation into its letter of credit. Every one of the recommendations made above, in one way or another, makes collecting on a demand more difficult. In addition to trying to avoid such clauses, the beneficiary should also try to include a few of its own for protection against injunction or non-payment.

⁴³⁹ Regulation M allows a foreign branch of a U.S. bank to issue a guarantee. See 12 C.F.R. § 213.3(b)(1) (1979). Domestic banks lack statutory authority to act as a surety. Land, *The No-Guaranty Rule and the Standby Letter of Credit*, 96 *BANKING L.J.* 46 (1979).

⁴⁴⁰ UCC Article 5, Letters of Credit, *supra* note 8.

1. Indispensable Party Clauses

Similar to Bank Melli's argument in *Itek*, a foreign confirming bank might like to see a clause requiring that the beneficiary be made a party to any litigation involving letters of credit.⁴⁴¹ Such a clause is also advantageous to the beneficiary. Not only would the beneficiary be given notice of any and all actions attempting to enjoin payment to him, but it would mandate that his side be heard. It would also require that the beneficiary be properly served and brought within the jurisdiction of the court.

2. Liquidated Damage Standbys

In addition to any good performance standbys the beneficiary can bargain for, he should also try to secure a liquidated damages standby. It would be payable on a demand showing any kind of termination, non-delivery, cancellation or repudiation of the contract whether or not the action was legitimate. For example, if there had been any liquidated damages standbys involved in the *Itek* case, Iran could have collected on them regardless of whether or not force majeure occurred. In another situation, suppose the buyer purchased the goods F.O.B., seller's plant. If the buyer's export license were cancelled or he was otherwise unable to pick up the goods, a liquidated damages standby could protect him.⁴⁴²

3. Sovereign Beneficiary's Relationship to Its Government Bank

If a sovereign beneficiary is involved in a letter of credit agreement, it should first try to make its government bank a confirming bank which will accept and pay on a conforming demand. Once this is agreed to, the sovereign beneficiary should attempt to include a clause in the letter of credit agreement stating that the government bank has no relation to the beneficiary which would disallow holder in due course status. As a result, once a demand was made, accepted and paid, no injunction could issue for fraud unless it could be shown that the bank had perpetrated it. In addition, a customer would be required to allege and show fraud on the beneficiary's part prior to demand, acceptance, and payment.⁴⁴³

4. Extendability Clauses

The beneficiary under a letter of credit has a real interest in the credit not expiring before the beneficiary has a legitimate reason to call on it. Therefore, the beneficiary should always try to bargain for an extendability clause which, in explicit terms, would allow the beneficiary to extend the expiration date of a letter of credit upon demand without consent of the customer. Finally, this clause should be worded so that the bank must either extend or pay without further demand on the part of the beneficiary.⁴⁴⁴

⁴⁴¹ Brief for Appellant Bank Melli at 35, No. 80-58 Slip op. at 3 (D. Mass., May 25, 1982), *Itek Corp. v. First National Bank of Boston* No. 82-1631 Slip op. at 24 (1st Cir. March 29, 1983) (finding the Ministry of War not an indispensable party).

⁴⁴² Under UCC § 2-718 liquidated damages are allowed in contracts so long as they are reasonable in the light of potential harm caused by a breach, difficulties of proof of loss, and the inconvenience of obtaining an adequate remedy. UCC § 2-718(1) *supra* note 8. Such requirements could be easily shown in a complicated international transaction.

⁴⁴³ So long as the bank is a holder in due course, this is the law. UCC § 5-114(2)(a), *supra* note 8.

⁴⁴⁴ See Brief for Appellant, Bank Melli, at 17, 18.

V. CONCLUSION

This article has had a dual purpose. First, it is an introduction to letters of credit, their varied uses, and the intricacies of the laws applicable to them. Second, it is a recommendation to those who use letters of credit, for whatever purpose, to adapt each letter of credit to its proposed use, and to do it according to the applicable law. If this means creating an appropriate document in order to adhere to the documentary standard, then this should be done. The most valuable aspect of a letter of credit is its guarantee of payment. The Iranian cases show that this guarantee is jeopardized when the documentary standard is abandoned in a standby letter of credit. A properly designed letter of credit should always be paid when a non-fraudulent conforming demand has been made. If parties to a letter of credit properly negotiate its purpose, and adapt it to letter of credit law, they will find that they are all better protected. They will also find that the letter of credit will be better protected as the valuable financial instrument it has become.

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