

ISSUER'S DUTY ON DEMAND FOR PAYMENT BY BENEFICIARY IN A STANDBY LETTER OF CREDIT TRANSACTION

I. INTRODUCTION TO THE STANDBY LETTER OF CREDIT

Letters of credit are bound to an underlying contract of some sort.¹ In a broad sense, they relate to performance by the account party or performance by the beneficiary pursuant to the underlying contract. If, for example, the underlying contract calls for the account party to pay the beneficiary for goods purchased, the letter of credit assures the beneficiary of payment. The letter of credit will be paid after certain performance by the beneficiary; that is, the issuer pays under the letter of credit when the beneficiary has complied with the terms of the credit. Such compliance will constitute performance pursuant to the underlying contract. The essence of this *commercial letter of credit*, is that if the beneficiary performs his obligations pursuant to the underlying contract, he is assured payment under the letter of credit. Should the beneficiary not perform, he will not be paid.

Payment may be triggered, however, by the action or non-action of the account party. The underlying contract may call

¹The UCC defines "letter of credit" as "an engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit." UCC § 5-103(1)(a). A credit is an original undertaking by one party (the issuer) to substitute his financial strength for that of another (the account party or customer). The credit arises in several situations, but generally the account party seeks the strength of the issuer's financial integrity so that a third party (the beneficiary of the credit) will give value to the account party. The beneficiary extends that value by selling goods or services to the account party on credit, by taking the account party's negotiable paper, or by extending credit to the account party.

for the account party to supply goods or services. The letter of credit is issued to assure the beneficiary of the payment of money if the account party fails to perform. Thus, the issuer will not pay under the letter of credit if the account party performs pursuant to the underlying contract, and will only pay if the account party *fails* to perform. This is called a *standby letter of credit* because the letter of credit is *standing by*, or *awaiting* the account party's non-performance to take effect.²

Letters of credit are governed by Article Five of the Uniform Commercial Code. While the standby letter of credit is a separate and independent obligation without reference to any other contract,³ there are three separate agreements that

²A standby letter of credit differs from a commercial letter of credit in that the beneficiary cannot draw on the standby letter of credit unless the customer defaults on its underlying agreement with the beneficiary. In re Liquidation of Valleywood Savings & Loan Assoc., 60 Oh.App.3d 64, 573 N.E.2d 1193 (1989). The advantage of a standby letter of credit is that the party obligated to perform is the account party, who causes the standby credit to issue in order to assure the promisee. While the account party (obligor) is performing, the beneficiary (promisee) who awaits that performance, has the benefit of a separate promise from the issuer that if the account party defaults, the issuer will pay the beneficiary money.

³The Code provides:

An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit *regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.*

comprise the standby letter of credit: (1) the business arrangement reflected in the underlying agreement between the bank's customer and the beneficiary; (2) the agreement between the issuing bank and its customer in which the bank agrees to issue the letter of credit and the customer agrees to reimburse the bank for any payments thereunder; and (3) the agreement between the issuing bank and the beneficiary set forth in writing in the letter of credit in which the bank is obligated to honor any drafts or demands that comply.⁴

The letter is separate and independent from the underlying transaction between the account party and the beneficiary. Independence prevents the parties to the underlying transaction from introducing into the credit transaction, matters which properly belong in the underlying contract. The beneficiary is thus protected because the account party cannot renege on the transaction, nor withhold payment for an alleged breach of warranty, if the documents submitted are in order.⁵

The legal relationships between the customer and the beneficiary turn on the underlying transaction between them. If the transaction is for the sale of goods, then their rights and

⁴In re Liquidation of Valleywood Savings & Loan Assoc., 60 Oh.App.3d 64, 573 N.E.2d 1193 (1989).

⁵The independence of the letter of credit from the underlying contract is most often asserted in cases where the account party seeks to enjoin payment of the credit as a result of a dispute regarding performance of the underlying transaction.

remedies depend on UCC, Article 2; if the transaction involves the sale of investment securities, Article 8 will be applicable; if the transaction involves the transfer of commercial paper, Article 3 will be applicable; if documents of title are transferred, Article 7 will be applicable; and if the transaction is intended to create a security interest, Article 9 will apply. The issuer is not a guarantor of the performance of these underlying transactions.⁶

This paper will focus primarily on the third relationship; and specifically on the point in time at which the beneficiary presents to the issuer certified presentment documents on demand for payment under the standby letter of credit.

II. THE BENEFICIARY AND THE ISSUER

At the time of acceptance of the account party's application for a letter of credit,⁷ the opening bank issues its letter of credit for the account party and in favor of the beneficiary. A letter of credit comes into being when the beneficiary is advised of its issuance. The letter states the documents that are required to be produced by the beneficiary upon its demand for

⁶Official Comment to UCC, § 5-103 at para 3.

⁷The term "letter of credit" will be used here interchangeably with the full term "standby letter of credit." Any differences between the two types will be indicated, should need arise.

payment.⁸ Failure to pay the draft within three days of beneficiary's compliance with the terms of the credit constitutes wrongful dishonor.⁹

A. Presentation of Documents by Beneficiary

The beneficiary has a duty to present conforming documents to the issuer to receive payment. The issuer, in turn, has a duty to the customer (i.e., account party) to examine the documents in order to determine that they comply on their face with the credit.¹⁰ The issuer, however, is not responsible for any defects in any document that is regular on its face. The bank, no matter what its suspicions, may not impose additional requirements upon the beneficiary. The issuer must honor the credit if these minimal requirements are met, despite claims by the account party that conditions in the underlying transaction may not have been complied with.

The issuer must examine with care the documents required under the credit. The purpose of the examination is to determine

⁸Commercial letter of credits require documents such as shipping documents (bills of lading, invoices, inspection certificates), while standby letters of credit usually require fewer documents, such as a draft and a statement of default.

⁹Under UCC 5-112(1), presentment is deemed rejected if not honored within three business days. However, under the UCP, dishonor must occur within a reasonable time after presentment and notice of rejection together with a statement of reasons for dishonor, which must be given without delay after the decision to reject is made. UCP Art. 16.

¹⁰UCC § 5-109 defines the issuer's duty to its customer.

whether the documents appear regular on their face. The fact that the documents may be false or fraudulent or lacking in legal effect is not one for which the issuer is bound to examine. His duty is limited to apparent regularity on the face of the documents.¹¹

The issuer assumes no liability or responsibility except as the agreement of the parties may indicate the contrary. Indeed, the issuer has no control over the making of the underlying contract or over the selection of the beneficiary. The customer's recourse lie directly against the beneficiary if performance fails. Thus the risk of the original bad faith action or fraud in the transaction by the beneficiary is thrown upon the customer who selected him, rather than upon the issuer.¹²

B. Issuer's Duty and Privilege to Honor

This situation begs the question of how does a bank decide if documents appear regular on their face and conform to the conditions specified in the credit. The International Chamber of Commerce has established the Uniform Customs and Practice (UCP) for Documentary Credits which is normally accepted by all parties

¹¹Official Comment to UCC, § 5-109 at para 2. The duties and rights of an issuer who has received documents which are regular on their face but are in fact improper because forged or fraudulent are dealt with in UCC § 5-114.

¹²Official Comment to UCC, § 5-114 at para 2.

involved in transactions of credits. The Uniform Customs attempt to remove technical problems and to guarantee the smooth operation of documentary credits. The UCP and Article 5 of the UCC are supposed to supplement and overlap one another but they do vary to a certain extent.¹³

Once a court gets involved, however, the strict law of contract may be weakened if the court perceives that the operation of law may yield unfair results. Good intentions such as the desire to protect consumers and inequity in bargaining power have produced, what some commentators have described as, the "death of contract". By relaxing strict rules of performance and by introducing equitable notions of good faith and unconscionability, courts have blurred distinctions in contract law and have rendered problematic the effort of reducing to express terms the conditions of a contracting party's undertaking.

Notions of inequality of bargaining power should not be applied to the letter of credit transaction. The letter of credit transaction is a mercantile, non-consumer transaction. Admittedly, it may entail some adhesion features, but it is obvious that letters of credit involve a level of commercial sophistication that amateurs may not attain. A keen judge would

¹³In Illinois, if a letter of credit specifies that it is governed by the UCP, provisions of the UCC can still govern to the extent not inconsistent.

observe that the letter of credit transaction is much more like the collection of a negotiable instrument or the negotiation of a document of title than the performance of a bilateral contract.

Courts, either, view the letter of credit strictly, and require that the beneficiary comply perfectly with the terms of the credit, or infuse equitable notions into letter of credit law.¹⁴ The latter approach, the substantial compliance approach, will modify the original terms of the arrangement under the cover of equity. It is obvious to see that this method does not lend itself well to the issuer's letter of credit department, where document examiners must review the documents against the credit and must decide promptly whether to honor the beneficiary's draft.

Thus, in determining whether a beneficiary has complied with the terms and conditions of a letter of credit, strict compliance should be the rule. But how *strict* should strict compliance be? If the beneficiary's documents contain discrepancies, but the discrepancies are so minor that they could not possibly mislead a reasonable document examiner, the discrepancies should be considered harmless and disregarded as a matter of law.

When a credit calls for a certificate of some sort, failure to provide that certificate renders the presentation

¹⁴The standby credit usually requires a certificate, and courts usually invoke the strict compliance rule against the beneficiary who fails to present such a document.

nonconforming and excuses the issuer from any duty to pay. The issuer may not add conditions to the certificate that the credit does not require.¹⁵ Deviation by the beneficiary in wording in the certificate from the letter of credit may cause the drawing to fail the strict compliance test.¹⁶ The strict compliance rule should be followed with a eye toward recognizing the inequality that would result if banks could simply dishonor letters of credit based on minor, trivial discrepancies that do not place in doubt the terms of the letter of credit.

C. Timeliness of Presentation

¹⁵Pringle-Associated Mortgage Corp. v. Southern Natl. Bk., 571 F.2d 871 (5th Cir. 1978) (credit referred to underlying agreement and issuer argued that the beneficiary needed to show that the credit funds would be used to complete the construction project that was the subject of the underlying contract; court rejected issuer's argument, holding instead that the credit's general reference to the underlying agreement was surplusage.

¹⁶American Natl' Bk v. Cashman Brothers Marine Contracting, 550 So.2d (Fla. Dist. Ct. App. 1989) (letter of credit set forth the exact wording required for the beneficiary certification regarding the account party's default: "The undersigned, being President or Treasurer hereby certifies [the account party] has failed to make satisfactory arrangements for payment." The certification submitted by the beneficiary added the words "I have determined," and read as follows: "The undersigned, being president or treasurer hereby certifies that *I have determined* that [the account party] has failed to make satisfactory arrangements for payment. Court upheld issuer's dishonor, stating that the deviation caused the beneficiary's drawing to fail the strict compliance test), but see, Employers Mut. Cas. Co. v. Tascosa Nat'l Bk., 767 S.W.2d 279, 283-84 (Tex.Ct. App. 1989) (letter of credit did not set forth verbatim beneficiary's certification; held, beneficiary's certification did not have to include words "certification" or "certify" where documents otherwise strictly complied with terms and conditions of credit).

The UCP specifies that all credits contain an expiry date for presentation of documents for payment, acceptance or negotiation.¹⁷ The expiry date specified in a letter of credit is the last date on which the beneficiary can present conforming documents. However, it is not the last date on which the issuer can make payment.¹⁸ If the first presentation is faulty for some reason, the beneficiary may correct the defect in a second presentation, provided it is within the expiry date.¹⁹

III. LETTER OF CREDIT LITIGATION

A. Injunctive Relief for Beneficiary's Fraud

There is a very limited exception to allow for the dishonor of a letter of credit in the case of fraud.²⁰ To avoid payment under a letter of credit the account party will usually resort to an injunction or restraining order against the draw. If the fraud is egregious and the proof is credible, the issuer may be persuaded to exercise its right to dishonor presentment on the ground of fraud. If fraud cannot be shown, the issuer can be

¹⁷UCP 400 art. 46; UCP 500 art. 40.

¹⁸Morgan Guaranty Trust Co. v. Vend Technologies, Inc. 100 A.D.2d 782, 474 N.Y.S.2d 67 (1st Dept. 1984) (court held that it was appropriate to honor the letter of credit subsequent to the expiry date so long as the conforming documents had been presented before the expiry date).

¹⁹First Nat'l Bk. v. Rosebud Hous. Auth., 291 N.W.2d 41 (Iowa 1980).

²⁰UCC § 5-114(2).

sued by the beneficiary for wrongful refusal to honor. It, however, will have a full indemnity from the account party.²¹ The account party must prove by clear and convincing evidence that the fraud was egregious and vitiates the entire transaction. The circumstances plainly must show that the underlying contract forbids the beneficiary to call a letter of credit.²²

A plaintiff must show the following to obtain an injunction:

1. A reasonable probability of ultimate success;
2. An necessity to preserve the status quo; and
3. A showing of *irreparable harm* or that there is an inadequate remedy at law.

Showing irreparable harm is the most difficult for the account holder. Indeed, little authority exists for enjoining payment under a letter of credit when the documentation presented is fraudulent or there is an alleged "fraud in the transaction."²³

²¹Bazaar v. Exchange Nat'l Bk., 168 Ill.App.3d 811, 523 N.E.2d 57 (1st Dist 1988).

²²Roman Ceramics Corp. v. Peoples Nat'l Bk., 714 F.2d 1207, 1212 (3d Cir. 1983).

²³Warner, supra, (citing KMW International v. Chase Manhattan Bank, 606 F.2d 10, 16 (2d Cir. 1979); In re Liquidation of Valleywood Savings & Loan Assoc. 60 Ohio App.3d 64, 573 N.E.2d 1193 (1989) (claim of false or fraudulent presentment of documents not available to enjoin payment under R.C. 1305.13(B)(2)). In Warner, the court vacated the TRO issued by the district court finding that:

In the context of a person such as Warner, a **sophisticated investor** seeking the extraordinary judicial intervention of prohibiting an 'irrevocable standby' letter of credit from being

The account party may complain that his remedy at law is inadequate because it would necessitate a suit in a foreign jurisdiction.²⁴ This argument should be dismissed because the account party chooses to do business with its foreign customer. The account party should not be able to weaken the commercial reliability of credits or the credit reputation of the issuer because the account party's bargain with the beneficiary has soured.²⁵ Moreover, the fraud that must be shown should relate directly to the letter of credit transaction. Fraud in the inducement to obtain the letter of credit is not considered enough.²⁶

honored, the test for a preliminary injunction is properly strictly applied in this instance. Setting aside or delaying payment, when due, of such a letter of credit imposes heavy burdens upon a party seeking such relief in a complex business transaction. We decline the district court's initiation to broaden the requirements in a case of this kind for issuance of a preliminary injunction.

Warner, supra, at 1124 (emphasis added).

²⁴American Bell International, Inc. v. Islamic Republic of Iran, 474 F.Supp. 420 (S.D. N.Y. 1979)

²⁵Carter H. Klein notes in "Letters of Credit in Financial Transactions," Advanced Commercial Finance and Creditors' Rights in Illinois, (ICLE, 1993) p. 10-38 that, "so difficult are the hurdles to enjoining a letter of credit draw in Illinois, no reported case of an Illinois appellate court has upheld such an injunction." (citations omitted). But see, Hubbard Business Plaza v. Lincoln Liberty Life Ins. Co., 649 F.Supp. 1310 (D.Nev. 1986) and Foxboro Co. v. Arabian Am. Oil Co., 634 F.Supp. 1226 (enjoining a draw on a standby letter of credit because of irreparable harm to the account party's reputation).

²⁶Aetna Life & Cas. v. Huntington Nat'l Bk., 934 F.2d 695 (6th Cir. 1991).

What must the issuer do if there is a strong argument by the account party that there was fraud in the credit transaction? Section 5-114(2) insists that even if fraud is present, the issuer is not under an obligation to dishonor. The issuer can honor, so long as he is acting in good faith. Recall that the issuer need not engage in extrinsic inquiries. Such a rule is practical; for while one may believe that the beneficiary who practices fraud in the credit transaction should not be entitled to payment, that does not mean, however, that the bank issuers should not pay and that courts should prevent payment every time the account party alleges fraud.

B. Customer's Remedy for Wrongful Payment

The issuer has the duty of good faith, general banking usage and to examine documents with care so as to ascertain that, on their face, they appear to comply with the terms of the credit.²⁷ If the issuer fails in these duties, he is liable to the customer under the statute and for breach of its contract to honor only conforming draws. One of the consequences of the issuer's breach is loss of reimbursement rights.²⁸

The issuer has a statutory and contractual right to reimbursement from the account party for draws on the letter of

²⁷UCC §5-109; UCP art. 15.

²⁸Resolution Trust Corp. v. Kimball, 963 F.2d 820 (5th Cir. 1992).

credit.²⁹ The UCC and the UCP give the issuer substantial protections from claims and disputes apart from the reimbursement agreement. UCC §5-109 disclaims the issuer's responsibility for (1) performance of the underlying contract between the account party and the beneficiary; (2) acts or omissions of others; (3) loss of destruction of documents in transmission (4) lack of knowledge of any usage of trade and (5) genuineness, falsification, or effect of any document that appears to be regular on its face.

IV. CONCLUSION

A beneficiary seeking payment on presentment, who wishes to avoid litigation arising out of an alleged fraud in the transaction, should avoid a credit conditioned on receipt of a copy of each document causing the credit to be called upon. The beneficiary should condition the credit precisely; for example, the credit should only require that the beneficiary certify that it has invoiced the account party and that the invoice is unpaid, or certify that the beneficiary has made demand on the account party who has not honored the demand. The beneficiary should take every effort to help liberal minded judges resist the temptation of looking to the underlying agreement.

In some cases, however, the account party's claim of fraud will open the credit transaction to inquiry. The law cannot

²⁹UCC §5-114(3).

ignore a charge as serious as fraud. Indeed, section 5-114(2)(b) explicitly permits courts to enjoin payments of credits when fraud arises in the credit transaction. Requesting the court to consider the issue, however, interrupts the credit transaction and destroys many of the credit's attractive commercial features. The credit was designed to achieve expedience and certainty. Fraud inquires smash both goals. Courts have imposed severe sanctions against parties raising the fraud question without good cause.³⁰ There does remain the danger that the account party's charge of fraud will result in a full-blown trial in the credit transaction of the ultimate dispute between the account party and the beneficiary, which is to say, the very result that the independence principle of the letter of credit is designed to avoid. In every case, even when the beneficiary is successful, delay of payment is present and, as a result, the efficiency of credit's will suffer.

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³⁰Bank of Canton, Ltd. v. Republic Nat'l Bk., 636 F.2d 30 (2d Cir. 1980) (awarding damages to appellee because of issuer's frivolous appeal) Les Mutuelles du Mans Vie v. Life Assur. Co., 128 F.R.D. 233m (N.D. Ill. 1989) (allowing F.R.C.P 11 sanctions against plaintiff, whose complaint for injunction against draws on letters of credit ignored applicable law and sought to override the fundamental nature of letters of credit as an arm's-length allocation of risk distribution).