IDENTITY CRISES IN LETTER OF CREDIT LAW

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As Captain Disko Troop, the seagoing sage of Kipling's *Captains Courageous* observed, "things should ha' bin kep' sep' rate."[1] Casual research has failed to disclose any judicial decision citing *Captains Courageous* in a letter of credit case, nor is it likely that Kipling was a student of letter of credit law. Whether by serendipity or sophism, however, Troop's aphorism epitomizes the utility of letters of credit. The independence of the letter of credit from other contracts, arrangements, and relationships involved in the transaction out of which the letter of credit arises is the cornerstone of its utility.

Encroachment of concepts that appropriately govern those other contracts, arrangements, and relationships does more than curtail the use and development of letters of credit. The rigid rules that govern letters of credit are structural. If they are subordinated to more pliable precepts appropriate to equitable resolution of disputes, the very existence of the letter of credit as a useful business device can be destroyed as surely as a wisteria vine can strangle an oak.

Just that danger has become increasingly discernible in the proliferation of letter of credit litigation that has marked the past decade. Courts as well as commentators appear to have embarked on a myopic reexamination of established legal principles that govern letter of credit practice. Reexamination, or even abandonment, of governing principles may well be a wholesome characteristic of a responsive legal system, but not when the governing principle is also a principle that defines a specific legal device or institution. Insofar as letters of credit are concerned, gross alterations in rules that both govern and define the device threaten its destruction as a discrete mechanism. As a consequence, letters of credit are faced with an identity crisis.

Two structural principles are in evident jeopardy: the rule that a letter of credit must be strictly construed and the rule that a letter of credit is

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1. R. KIPLING, XVI COLLECTED WORKS 93 (1941) and *semble*, Long Jack, "There's power av vartue in keepin' things sep'rate." *Id.*

independent of other, but related, contracts, arrangements, and relationships. The purpose of this article is to demonstrate that these rules are doctrinal rather than dogmatic in that they serve to differentiate letters of credit from other legal instruments or relationships, and that, therefore, their maintenance is essential.

The Rule of Strict Construction

The rule of strict construction is most succinctly stated in article 8 of the Uniform Customs and Practice for Documentary Credits[2] (UCP) and *Equitable Trust v. Dawson Partners*.[3] Article 8 states, "In documentary credit operations all parties concerned deal in documents and not in goods."[4] In *Equitable Trust* the court said, "There is no room for documents which are almost the same, or which will do just as well."[5] In application, the rule may appear to conflict with the proposition that a commercially reasonable substitute for literal performance is acceptable. It is therefore not surprising to find that the continuing validity of the rule of strict construction is faced with recurrent challenges. In a number of cases, courts have refused, explicitly or implicitly on equitable grounds, to apply the rule, or have found that some such ground as waiver or estoppel made its application inappropriate. Such decisions are generally found at the trial level, and the vast majority are reversed or repudiated on appeal. There remain, nevertheless, exceptions that endanger and may well erode the rule unless the reason for the rule is clearly understood. As will be argued hereafter, the rule of strict construction is pragmatic rather than formal and is, when understood, a rule of equity as well as of law.

The Rule of Independence

There is a conceptual affinity between the rule of strict construction and the rule that a letter of credit is independent of any other contract, arrangement, and relationship with which it may be linked transactionally. Strict construction of the letter of credit contract implies that in the construction of a letter of credit only the credit's terms may be consulted and not the terms or considerations relevant to other relationships. Similarly, the rule that a letter of credit is independent of other arrangements with which it may be linked implies both that it is to be construed exclusively in accordance with its own specific terms and that it is to be construed only at the instance of one who is a party to it.

Sources of Dissidence

In most instances, objections to the rule of independence come from the party for whose account the letter of credit is issued, rather than from the beneficiary. Seen from the beneficiary's point of view, the indepen-

2. UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (I.C.C. Pub. No. 290) (rev. 1974) [hereinafter U.C.P.].
3. 27 Lloyd's List L.R. 49 (1927).
4. U.C.P., *supra* note 2, at art. 8(a).
5. 27 Lloyd's List L.R. 49, 52 (1927) (Viscount Sumner).

dence of the letter of credit is its prime virtue because it relieves him from concern that the account party may be unwilling or unable to perform his engagement to pay the beneficiary. The beneficiary, therefore, may decry a rule of construction that requires strict performance of the terms of a letter of credit, but he will certainly applaud a rule that precludes the issuer of the credit from withholding payment on the ground that there has been deficient performance of some obligation other than that precisely specified in the letter of credit.

The account party, on the other hand, approves a rule that obliges the beneficiary to comply literally with the terms that the account party has caused the issuer to incorporate in the credit, but is aggrieved if the beneficiary, by formal compliance with the terms of the credit, obtains payment for insufficient performance of the contract that the credit was intended to facilitate.

Conflict of Concepts

The dramatic increase in letter of credit litigation in recent years has produced an interesting paradox. The rules of letter of credit law are attacked because they appear to prefer formalism over the realities of commerce. At the same time, and as discussed below, the assailants disregard the very commercial realities out of which letter of credit practice has grown.

The purpose of a letter of credit and the reason for its use is that one party to a contract is unwilling to rely on his counterparty's unsupported engagement to pay money. That unwillingness may be rooted in a number of reasons.

The one most often mentioned is lack of confidence in the counterparty's solvency. Even though the counterparty is solvent, unless he is known to be so, and particularly in international transactions, his promise to pay may not have value as a borrowing base. Not so often discussed, but of major importance, is the matter of the counterparty's reputation (or lack of it); a letter of credit provides considerable assurance that payment will not be withheld pending resolution of commercial disputes.[6] By the same token, an account party who has stipulated that his banker pay against a certificate of quality issued by George Washington Successors would be aggrieved if payment against a certificate issued by Ananias Associates could be justified on the ground that the merchandise shipped was a commercially reasonable substitute for that described in the sales contract. The independence of the letter of credit is thus essential both to the beneficiary and to the account party.

Such independence is equally essential from the point of view of the issuer of the credit. The issuer undertakes a direct and primary obligation to the beneficiary. The nature and scope of that obligation must be defined, and is defined, by the terms of the credit rather than by the terms of

6. Unfortunately, but all too frequently, such disputes arise out of insubstantial objections. Some merchants have been known to assert frivolous claims in order to renegotiate a price or otherwise evade the consequences of a bad bargain.

a contract or arrangement to which the issuer is not a party and in the formation or performance of which the issuer has no role.

Therefore it is (or should be) evident that independence of the letter of credit is definitive of the instrument. It is the benchmark that distinguishes letters of credit from equally useful but quite separate forms of contract such as guaranties, insurance policies, and the like.[7] Thus, in letter of credit disputes there is no genuine conflict between the concepts of strict construction and of equity, or between formalism and reality.

That conclusion is supported by analysis of cases involving alleged fraud. The point of beginning is the landmark case of *Sztejn v. Schroder Banking Corp.*[8] In that case, the factual assumption was that the beneficiary of the credit committed an outright and deliberate fraud on the account party. Justice Shientag noted the rule of the independence of the letter of credit but held that "the principle of the independence of the [issuer's] obligation under the letter of credit should not be extended to protect the unscrupulous [beneficiary]."[9]

In the numerous and largely illegitimate progeny of *Sztejn*, the significance of the independence of the issuer's obligation, which Justice Shientag characterized as a principle, has been overlooked. The concern of courts and commentators alike has been with the circumstances, if any, that justify judicial intervention to enforce payment when the beneficiary fails to observe the letter of the commitment, or to restrain payment when the beneficiary violates the spirit of the commitment. The issue is generally framed in this way: In equity and good conscience, should the beneficiary be denied payment when he has made substantial, although not literal, performance, should the beneficiary be able to enforce payment by literal performance when his actual performance is such that, in equity and good conscience, he is not entitled to receive payment?

It may be appropriate to frame issues in that way when the competing interests are directly opposed and no third party interest is involved. It is not appropriate to do so in most letter of credit cases because the independent interest of the issuer is adversely and unfairly affected. In short, it is not the application to letters of credit of principles of equity and fair dealing that is inappropriate. The mischief lies in misapplication of those principles through ignorance or disregard of the extent of the issuer's obligation, so that the issuer's equities are not taken into account.

The *Sztejn* case and the Uniform Commercial Code (UCC)[10] both give explicit recognition to the subordination of the equitable rights of an aggrieved account party to the equitable rights of one who has become a bona fide holder of a claim to payment under a letter of credit. Thus, even though documents tendered under a letter of credit are known to be forged or false, the presenter must be paid if he took the documents without notice of their latent defects and in circumstances that would make him a

7. *See* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F.2d 1285, 1286 (9th Cir. 1974).
8. 177 Misc. 719, 31 N.Y.S.2d 631 (1941).
9. *Id.* at 722, 31 N.Y.S.2d at 634.
10. U.C.C. § 5-114.

bona fide holder of the draft or other demand under a negotiation credit. Moreover, an issuer or confirmer who has paid against documents without knowledge of latent defects is entitled to reimbursement from the party at whose instance the credit was established. The same result is achieved by application of the rule of strict construction of the letter of credit treated as an independent contract.

The Creditanstalt *Illustration*

The recently terminated litigation between Singer & Friedlander and Creditanstalt is instructive.[11] Briefly stated, and somewhat oversimplified, the facts were as follows: Aronson, an entrepreneur in the Netherlands, proposed a deal to two Austrian trading companies (hereinafter collectively referred to as "Waren"). Aronson represented that he had an arrangement to sell a vast quantity of a particular antibiotic product to Interimpex, a Yugoslav company. The purchase price was to be secured by a letter of credit from a Yugoslav bank.[12] Because of alleged restrictions of Yugoslav law, that letter of credit could not be issued for a term of sufficient duration to meet Aronson's needs. Aronson therefore proposed that Waren should undertake the purchase from him of the antibiotics, simultaneously entering into an arrangement to resell them to Interimpex. Pending establishment of the Yugoslav bank letter of credit in favor of Waren, Interimpex's obligation to pay the price of resale would be secured by a guaranty from Garant, a Soviet credit insurance company. Under Aronson's proposal, Waren's obligation to pay him for the antibiotics would be secured by a letter of credit issued in favor of Aronson by Creditanstalt. Waren accepted the proposal. For Waren's account, Creditansalt thereupon opened, in favor of Aronson, a straight, non-transferable letter of credit whereby Creditanstalt undertook to make payment against Aronson's demand accompanied by Aronson's orders to a Swiss warehouse to deliver the described antibiotics.

Singer & Friedlander, an English banking house, notified Creditanstalt that, in connection with the extension of credit by it to Aronson, Aronson had assigned to Singer & Friedlander all his rights and benefits under the Creditanstalt letter of credit. Then, or soon thereafter, Singer & Friedlander exhibited to Creditanstalt delivery orders purporting to be executed by Aronson that were to be or which exemplified the documents described in the letter of credit. Creditanstalt acknowledged receipt of the

11. Singer & Friedlander v. Creditanstalt—Bankverein, 17 Cg 72/80 (Handelsgericht Wien 1980) (English translation on file with the *Arizona Law Review*). *See* R. DAVIES, COMMERCIAL LAW REPORTS 21 (Apr. 1981). The litigation was complex, directly or indirectly involving a multitude of characters, a profusion of facts and uncertainties, and a Babel of contentions. The author has endeavored to present fairly and completely the facts and arguments relevant to the issues discussed in this article; he does not represent or warrant that his presentation describes all the factual and legal issues involved in the litigation, nor all the contentions of all the parties, nor even that his statement of arguments made by any party accurately reflects what the party meant to say as distinct from what that party said or seemed to say. In short, the author will view with extreme disfavor, and will disregard, any nit-picking.

12. There were, in fact, several transactional segments of the arrangement, and at least three letters of credit were involved. For the reasons given in the preceding footnote, the case is stated as if only one transaction and one letter of credit were involved.

notice of assignment and "pre-confirmed" the facial conformity of the delivery orders.

Subsequently, Waren received from Interimpex or Garant, or both, information indicating that Interimpex declined to perform its contract and that Garant had withdrawn its guaranty. The communications stated or implied, and in any event caused Waren to infer, that Arsonon was engaged in perpetration of a fraud. Much distressed at this news, Waren instituted an investigation, as a result of which it concluded that the goods covered by Aronson's delivery orders were not antibiotics, but relatively worthless substances.

With all this as background, Creditanstalt refused payment under the credit when a representative of Singer & Friedlander presented documents. In the ensuing litigation, Creditanstalt defended on the grounds, *inter alia*, (a) that the letter of credit was non-transferable and thus Singer & Friedlander could not be substituted as a principal in the place and stead of Aronson; (b) that Aronson's fraud infected the letter of credit as well as the commercial transaction; and (c) that the documents were false and their tender as those required by the credit was fraudulent.

Singer & Friedlander argued, *inter alia*, (a) that in the circumstances they were entitled to claim directly against Creditanstalt as principals and not in the place and stead of, or as agents or representatives for, Aronson; (b) that the documents presented were admittedly in facial conformity with the terms of the credit; and (c) that as they had acquired the delivery orders in good faith and for value, and were bona fide holders of those documents, they were entitled to enforce the terms of the credit free of any defenses that Creditanstalt might have had against Aronson.

The Austrian court rendered judgment for Creditanstalt. The judgment is lengthy, intricately constructed, and the English version has doubtless suffered in translation. It seems to be based, in essence, on the proposition that a non-transferable credit is non-transferable and the beneficiary may not convert it to a transferable credit by alienating such rights and benefits (*i.e.*, proceeds) as he may have earned by his performance.[13] Further, while the court said, "In this case the court agrees with the almost universal doctrine that the plea of fraud is admissible," it did not appear to reach the question of whether in this case the ultimate fact of fraud was deducible. The controversy was subsequently terminated by extra-judicial compromise.

The judgment has been bitterly criticized (mainly by Singer & Friedlander or those affected with its interest) and, in all the circumstances, the extent of its precedential value may be doubtful. The anatomy of the case, however, lends itself to examination of the apparent conflict between the rules of strict construction of an independent contract on the one hand and, on the other, application of equitable principles to resolve all aspects of a dispute among all interested parties. Of particular interest is the role

13. "You can't give what you ain't got." Anon., *cited with approval in* H. HARFIELD, LETTERS OF CREDIT 95 (1979).

of fraud in the underlying transaction as distinct from fraud in the letter of credit transaction.

An initial objection to payment under the credit was, in the language of the Uniform Commercial Code, which has not been enacted in Austria, Switzerland, or England, that there was "fraud in the transaction."[14] On the facts alleged, there could be little doubt that Waren's agreement to buy was induced by fraud. That genetic defect in the underlying transaction would almost certainly have been insufficient under Austrian or English law, and probably insufficient under United States law, to justify an order restraining Creditanstalt from making payment under the credit. If, on the other hand, the allegedly fraudulent representation that Waren had a guaranteed resale was the sine qua non for Creditanstalt's issuance of the credit, and there was evidence to that effect, it might be argued that fraud in the inception infected and thus vitiated the letter of credit itself.[15]

Quite a different issue was raised by the fraud or falsification involved in the tender of delivery orders that represented trash rather than treasure. A vociferous argument was made by Continental law pundits that facial conformity of the documents precluded non-payment notwithstanding the latent insufficiency of those documents, or, at least that payment could not be withheld unless there had been a final determination of falsity prior to presentation. That argument, which was apparently based on the supposition that justice is not only blind, but also deaf and dumb, had little effect and was clearly unsupported in Anglo-American jurisprudence. Perhaps the clearest statement is found in *Old Colony Trust Co. v. Lawyers' Title & Trust Co.*[16] "Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit."[17]

The UCC and antecedent case law in the United States, of course, have put a gloss on that dictum. Even though the issuer need not recognize false or illegal documents as complying with the terms of the credit, he must make payment if honor is demanded by one who "has taken the draft or demand under the credit"[18] *and* in circumstances that would constitute him a bona fide purchaser or holder in due course.

It was to this point that Singer & Friedlander principally addressed itself. It pointed out that it had paid value for Aronson's assignment of all his rights and benefits under the credit, and that it had become the holder of the operative documents for value and without notice of any falsity or fraud, either in those documents or in the transactions underlying the credit. It contended, therefore, that (a) it had acquired the right to present documents under the credit; and (b) as it was a bona fide holder of the

14. U.C.C. § 5-114(2).

15. *See, e.g.*, Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077, 1080 (6th Cir. 1977); Baker v. National Boulevard Bank, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975); NMC Enterprises, Inc. v. Columbia Broadcasting Sys., Inc., 14 U.C.C. Rep. 1427, 1429-30 (N.Y. 1974). But bear in mind that United States law did not govern the *Creditanstalt* case.

16. 297 F. 152 (2d Cir. 1924).

17. *Id.* at 158.

18. U.C.C. § 5-114(2)(a).

documents, it was not subject to defenses based on their latent insufficiency.

Its initial hurdle, of course, was the undeniable fact that the credit by its terms was not transferable. That fact, Singer & Friedlander argued, was of no significance, for two reasons.

First, whether or not the credit was transferable, so as to constitute Singer & Friedlander a direct beneficiary, Aronson's assignment of all his rights and benefits included the right to present documents and to be paid against such presentation.

Second, the totality of the dealings between Singer & Friedlander and Creditanstalt in respect of the credit was such as to create a novation, so that Singer & Friedlander was, in effect, substituted for Aronson as beneficiary. This theory could be articulated in a different way; namely, that a new contract came into being whereunder Creditanstalt was obligated to pay Singer & Friedlander upon the latter's delivery of certain identified pieces of paper, without regard to whether the pieces of paper were what they purported to be or had any value. Such a contract would be difficult to infer, absent a stipulation that the personnel of Creditanstalt and Waren were idiots. Neither of the alternate contentions greatly advanced Singer & Friedlander's cause, because neither did more than confer on Singer & Friedlander the right to enforce the terms of the credit. Those terms could not be satisfied by presentation of false or fraudulent documents.

The ultimate and determinative question, therefore, was whether Singer & Friedlander, as a bona fide purchaser from Aronson of all his rights and benefits under the credit and as a bona fide holder for value of documents in facial compliance with the terms of the credit, could enforce Creditanstalt's engagement. That question could rationally be answered only after analysis and definition of Creditanstalt's engagement. The engagement was set forth in the letter of credit, and the letter of credit itself was engrossed on a form approved by the International Chamber of Commerce and in general international use.

The credit was "straight" and non-transferable. Under the UCP, which was explicitly incorporated, the non-transferable aspect meant that the beneficiary (Aronson) was required as a condition of the issuer's promise to meet the terms of the credit himself or under his responsibility; he was authorized, however, to dispose, by assignment or otherwise, of whatever payments or proceeds he earned by his performance of the terms and conditions of the credit. The use of a "straight" credit signified that the issuer's engagement was with the beneficiary alone. It can best be described by contrasting it with a negotiation credit, for which a separate form is in international usage, which extends the issuer's engagement to third parties who have, in good faith, purchased from the named beneficiary his draft or demand "drawn under and in accordance with the terms and conditions" of the credit.

In functional terms, the non-transferable "straight" credit issued to Aronson was closely akin to an undertaking to buy from him described documents. It was not an undertaking to take and pay for documents that were not as described or which were false or otherwise not "in point of fact" what they purported to be. Neither was it an open engagement to buy those documents, genuine or not, from whoever happened to own them.

Thus, because Creditanstalt's engagement was explicitly limited, the fact that Singer & Friedlander was a bona fide purchaser and holder of the documents conferred on it no right to enforce Creditanstalt's engagement to buy those or similar documents from Aronson. On this construction, there is no need to engage in such quasi-metaphysical exercises as definition of "fraud in the transaction," or ascertainment of what, if any, latent defects in documents justify dishonor, or whether the innocence or bona fide ignorance of the presenter requires honor when dishonor would otherwise be justified.

The factual framework of the Creditanstalt litigation dramatically illustrates the perils inherent in dilution of the rule of strict construction by considerations of ad hoc morality. Under the most literal application of the rule, honor would have been required notwithstanding any latent defects in the documents; the promise was to pay against a specifically designated document, and that document was presented. But, under the same rule, honor was not required because the promise did not run in favor of the one seeking to enforce it.[19]

The Ethic of Strict Construction

Erosion of the rule of strict construction, with which the independence of the letter of credit contract is inextricably woven, is encouraged by academics and some legislators and judges contribute to it because rigorous application is perceived as productive of unconscionable results. Justice weeps when payment under a credit is refused because presentation was made at 9 a.m. on Tuesday instead of 5 p.m. on Monday, the expiration date, leaving the beneficiary with a valid but useless claim against an insolvent account party. Conscience is affronted when payment is made under a credit against an invoice for woolen underwear notwithstanding the fact that the merchandise is moth-eaten, leaving the account party with a valid but ineffective claim against an irresponsible beneficiary in a faraway country.

More than 100 years ago Jessel, M. R., sitting in equity, said, "This Court is not, as I have often said, a Court of conscience, but a Court of Law."[20] Nevertheless, the hosts of Conscience, like roaches, are a hardy breed. If, as Conscience, they are not received in the courts, they seek with increasing success to return as Law. The Uniform Commercial Code decrees that every contract "within this Act" imposes an obligation of good faith in its performance or enforcement.[21]

The observer is forced to conclude, therefore, that the rule of strict

19. The dilemma does not imply starvation of the bar. If the triers of the facts had found that the dealings between Singer & Friedlander and Creditanstalt resulted in a de facto amendment of the credit that made it a negotiation rather than a straight credit, different legal and practical considerations might have come into play.

20. *In re* National Funds Assurance Co., 10 Ch.D.. 118, 128 (1878).

21. U.C.C. § 1-203.

construction of a letter of credit as an independent contract cannot be defended successfully if, as its denigrators imply, its application is inconsistent with conscientious behavior. In the words of Powell, J., then, "Let us consider the reason of the case; for nothing is law that is not reason."[22]

The reason for any contract, using the word contract to embrace any agreement or arrangement that describes prospective action by the parties, is to record the obligations that the parties undertake. A contract is a memorial of who does what, when, where, and how. The realities of a contract dispute, therefore, involve ascertainment of the expectations of the parties in order to the extent possible to realize those expectations that are reasonable. Liability for breach of contract, unlike liability for tort or breach of trust, results from default in performance of an obligation consciously assumed, rather than from failure to behave in accordance with an imposed standard.

A letter of credit creates a contractual relationship between the writer and the addressee. The writer (issuer) undertakes a legally enforceable obligation. When the credit is stated to be irrevocable, the issuer cannot terminate or alter the nature of that obligation without the consent of the beneficiary. Although the issuer undertakes the obligation at the instance of and in the expectation that a third party will indemnify it for its performance, frustration of that expectation does not relieve it of its obligation to the beneficiary. The independence of the letter of credit must, therefore, be recognized as an incident of the issuer's right to define at the outset the obligation it is prepared to undertake. Equally, definition of the obligation defines the reasonable expectations of the parties. The rule of strict construction does no more, or less, than reflect the terms of the obligation that the issuer has undertaken. Neither the beneficiary nor the account party can reasonably expect that the issuer is bound to perform any different obligation.

Analysis in terms of obligation rather than in terms of equitable entitlement reconciles the dicta of an eighteenth century English judge and a nineteenth century Gloucester fisherman. In letter of credit transactions, the "reason of the case" is that things must be "kep' sep' rate."

A Series of Hypotheticals

Analysis in concrete terms will be aided by construction of hypothetical cases that exemplify the propositions. Judas & Sons, a Lebanese partnership, enters into a contract with Barabbas Bros., a Delaware corporation. The contract provides that Judas will sell and Barabbas will buy 100,000 barrels of Libyan oil at a price of $50 per barrel, F.O.B. Tripoli. Judas and Barabbas know each other only by reputation, which makes both of them nervous. Barabbas enters into a contract with Colossal Bank, N.A., a bank organized under the laws of the United States, with its principal office in New York. That contract provides that Colossal will, for account of Barabbas, issue an irrevocable letter of credit in favor of Judas,

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22. Coggs v. Bernard, [1703] 2 Ld. Raym. 909, 911, 92 Eng. Rep. 107, 109 (1909).

and Barabbas will reimburse Colossal for payments made thereunder, if in accordance with the terms of the credit. Colossal issues its irrevocable letter of credit in favor of Judas, thereby undertaking a contractual obligation to Judas to pay an amount not in excess of $5,000,000, available by Judas' single sight draft on Colossal accompanied by invoice for Virgin Libyan Oil, clean on-board bill of lading to shipper's order, blank endorsed.

CASE 1. Following establishment of the credit, but prior to any shipments by Judas, the price of oil declines to $39 per barrel and Barabbas is declared bankrupt. Colossal advises Judas that the credit is cancelled. The advice is ineffective. By establishment of its irrevocable credit, Colossal obligated itself to pay against documents. Neither a decline in the anticipated value of those documents nor the inability of Barabbas to perform its reimbursement contract relieves Colossal from that obligation.[23] If conscience were king, Colossal would have an appealing defense; it is, in effect, being forced to pay out of its own pocket (or vault) the benefit of a bargain made between Judas and Barabbas. But in a court, whether of law or equity, it is held to performance of the obligation it undertook; it is the victim, as Judas' and Barabbas' other creditors are the beneficiaries, of the rule that a letter of credit is an independent contract to be strictly construed as such.

CASE 2. Judas draws under the credit. Colossal refuses to pay on the ground that the bill of lading is drawn to the order of Barabbas, rather than to shipper's order, blank endorsed. Judas argues (a) that there has been complete and perfect performance by it of the Judas/Barabbas contract; (b) that Barabbas has obtained and resold the oil; and (c) that therefore it is inequitable to excuse Colossal from its payment engagement. These arguments are unavailing as a matter of law.[24] The obligation undertaken by Colossal was to pay against the document described in the credit. It undertook no obligation to pay against any other document, even if that other document was "almost the same" or would "do just as well".[25]

Moreover, Judas' arguments would be unavailing in a court of equity or even a "court of conscience" because the document tendered would not "do just as well" as the one specified in the credit. Unlike the document tendered, a bill of lading to shipper's order, blank endorsed, would have given Colossal dominion over the oil, thus providing some security for its right to reimbursement from the bankrupt Barabbas. Strict construction of the independent letter of credit contract, therefore, is not obeisance to formalism, but a necessary recognition of the realities of commerce.

CASE 3. Judas presents documents in perfect facial conformity with the terms of the credit, including a bill of lading reciting receipt of Libyan

23. A letter of credit is a contract between the issuer and the beneficiary. It is wholly independent of the contract or arrangement between the beneficiary and the account party. Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 357, 336 A.2d 316, 323 (1975); U.C.P., *supra* note 2, General Provision (c). It is equally independent from the contract or arrangement between the issuer and the account party.

24. *See* Key Appliances, Inc. v. First Nat'l City Bank, 46 A.D.2d 622, 359 N.Y.S.2d 866 (1974), *aff'd*, 37 N.Y.2d 826, 339 N.E.2d 888, 377 N.Y.S.2d 482 (1975).

25. Equitable Trust Co. v. Dawson Partners, 27 Lloyd's List L.R. 49 (1927).

oil on board the Knesset Lines steamer "Shalom" at Tripoli, and signed "Y. Arafat, Master." Colossal refuses to pay, on the ground that the bill of lading is a forgery. If the fact is that the lading is a forgery, the refusal to pay is justified. The obligation undertaken by Colossal was to pay against a bill of lading, not against a document which in fact was not a bill of lading.[26] In litigation posture, however, Colossal must sustain the burden of persuading the trier of fact that the document was a forgery.

Assume now that Colossal (or its computer) made payment under the credit and now demands reimbursement from Barabbas. Barabbas is outraged. He not only claims that the bill of lading is a forgery, he supports his claim with testimony of handwriting experts, an affidavit from Knesset Lines, and a sworn confession from Judas. He is clearly entitled to relief from Judas, who is in flagrant violation of the obligations undertaken under the Judas/Barabbas contract and imposed by section 5-111 of the UCC. He is not entitled to relief from Colossal because neither under the Barabbas/Colossal contract pursuant to which the credit was established nor under articles 8(b) and 9 of the UCP did Colossal undertake an obligation to be responsible for the genuineness of documents presented under the credit.

CASE 4. Prior to any presentment under the credit, Barabbas makes a written representation to Colossal that (a) Judas had agreed with Barabbas that if the price of oil on the spot market declined to $42 per barrel he would reduce the price of the Virgin Libyan to $49 from the $50 per barrel contract price, reducing his drawings under the credit accordingly; and (b) that, instead of Virgin Libyan oil, Judas was shipping used crankcase oil of Indonesian origin. Barabbas warns Colossal not to pay under the credit. Simultaneously, Colossal receives a telex from Judas, reading, "Re your credit XY436985 whatever Barabbas says I deny it." In these circumstances, Colossal advises Barabbas that if Judas presents documents which on their face appear to be in accordance with the terms of the credit, Colossal will pay. It points out to Barabbas that this was the obligation it had undertaken; it had not undertaken to adjudicate, at its peril, disputes between Judas and Barabbas.

Intoning UCC section 5-114(2)(b) all the way to the courthouse, Barabbas applies for an injunction restraining Colossal from making payment under the credit. Section 5-114(2)(b) is not of material aid to the court. If the court is of "appropriate" jurisdiction (a term that deserves careful attention), it "may" enjoin honor. Whether it should and will depends on the facts of the case, illuminated by decisional law. That law, in the United States, is fairly clear.

First, the general rules governing preliminary injunctive relief apply. The applicant for the injunction must show that he is likely to prevail in the litigation and that he will be irreparably damaged unless the injunction issues.[27].

26. *See* Old Colony Trust Co. v. Lawyers' Title & Trust Co., 297 F. 152, 158 (2d Cir.), *cert. denied*, 265 U.S. 585 (1924).

27. Wainwright Sec., Inc. v. Wall St. Transcript Corp., 558 F.2d 91, 94 (2d Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978); Washington v. Walker, 529 F.2d 1062, 1065 (7th Cir. 1976).

Second, if the documents are clearly not what they purport to be and if the party demanding honor is not a bona fide obligee under the credit, the injunction will issue.[28]

Third, if the account party (applicant for the injunction) seeks the remedy in the context of a commercial dispute with the beneficiary, *e.g.*, a claim for breach of contract, the injunction will not issue.[29]

Thus, on the facts assumed in hypothetical Case 4, shipment of used Indonesian crankcase oil instead of virgin Libyan oil provides a legal basis for injunction; breach of Judas' promise to adjust the price term of his contract with Barabbas does not. If the issues are examined on the basis of obligation, however, discrete equitable considerations appear that alter the "reason of the case."

At the inception of the transaction Judas and Barabbas undertook mutual obligations defined and memorialized in the contract between them. Neither party was content to rely on the unsupported obligation of the other. Each, therefore, sought the obligation of a third party as assurance that their respective expectations would be realized. That assurance could be in the form of a guaranty by Colossal that Judas would perform its duties of timely delivery of oil as specified in the sales contract and that Barabbas would perform its duties of timely and full payment of the purchase price. Putting aside the question of whether such a guaranty would be ultra vires, it would be imprudent for a bank to undertake the responsibility for ascertaining whether a contract to which it was not a party and in the performance of which it had no role was in fact duly performed. Colossal was not willing to assume that obligation. It was prepared only to assume an obligation to pay money on conditions stipulated by it. It was prepared to assume the risk of non-reimbursement if it made payment notwithstanding failure of its obligee to meet those conditions. Its commitment as the issuer of a letter of credit rather than as a joint venturer, a guarantor, a trustee, or an insurer defined the nature and extent of the obligations it undertook. Therefore, interference with performance of a letter of credit as an independent contract in order to do equity as between account party and beneficiary denies effect to the equities of the issuer.

That conclusion seems unarguable when the issue is drawn between beneficiary and issuer. An irrevocable letter of credit is akin to an offer. Once communicated to the beneficiary it cannot be withdrawn nor may its terms be altered without his consent. It may be enforced, however, only if it is accepted in terms. Presentation of documents that are almost the same or which will do just as well is a counter-offer that the issuer is entitled to reject. Were it otherwise, the issuer would sustain liability on account of an obligation he never undertook.

28. *See* Sztejn v. Schroder Banking Corp., 177 Misc. 719, 722, 31 N.Y.S.2d 631, 634 (1941).

29. *See* Foreign Venture Ltd. Partnership v. Chemical Bank, 59 App. Div. 2d 352, 356, 399 N.Y.S.2d 114, 116 (1977).

Enter the Issuer

When the issue is drawn between account party and issuer there are superficial distinctions that should not, but do, give rise to debate. Most frequently, an account party seeks judicial intervention to prevent an issuer from honoring a credit on grounds enumerated in UCC section 5-114(2). In that situation, the account party must (and by hypothesis, does) make a prima facie case by showing that payment under the credit would consummate fraud of which he, the account party, will be the victim. In most instances there can be no immediate refutation. The issuer, although formally the defendant and adversary party, has no knowledge of the facts on which the claim is based and is in no position to resist on the merits of the claim. The alleged malefactor is not a party to the proceedings. As a practical matter, therefore, the court may be obliged, as Justice Shientag was in *Sztejn*, to accept the allegations of fraud as true, and may be disposed to agree with Judge Edenfield's dictum in *Dynamics Corp.* that "there is as much public interest in discouraging fraud as in encouraging the use of letters of credit."[30] The plaintiff (account party) will doubtless seek to reinforce his prayer for relief by arguing that issuance of an injunction will in no way expand the issuer's obligation. Rather, it will serve to relieve the issuer, in whole or in part, from the obligation it undertook in the letter of credit. In short, when the issue is as to the propriety of judicial intervention to prevent payment, the question of the issuer's equities does not arise—or does it? In the view of this writer, it does.

In practical effect, the injunction proceedings require the issuer to take action it did not bargain for. By interfering with performance of the issuer's obligation to the beneficiary, there is an implicit enlargement of the issuer's obligation under its contract with the account party and an erosion of its rights against the account party under that contract. Restrictions of time and space do not permit an exhaustive demonstration of the adverse consequences to the issuer. It should suffice to exemplify them by examination of one case recently decided and one that has not yet arisen but which might arise.

The first case is *Bank of Canton, Ltd. v. Republic National Bank*.[31] For account of Sharp, Republic issued a letter of credit in favor of EACA, covering shipment from Hong Kong of TV Games. The credit included an invitation to negotiate, *i.e.*, an engagement with "bonafide holders of drafts drawn under and in compliance with the terms of this credit . . . ." The credit required presentation of various shipping documents and a government certificate in addition to draft and commercial invoices. Bank of Canton negotiated EACA's documentary draft under that credit and claimed payment from Republic. Republic withheld payment on the ground that its customer, Sharp, claimed that there were discrepancies in the documents. Canton disputed the claim.[32] Prior to payment by Republic, Sharp applied to and obtained from a New York court an injunction

30. Dynamics Corp. v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973).
31. 509 F. Supp. 1310 (S.D.N.Y. 1980).
32. *Id.* at 1311.

restraining Republic from paying. Canton thereafter commenced an action against Republic in the federal court for the Southern District of New York. Republic defended on the grounds, among others, that the documents did not conform, that corrected documents were not timely presented, that there was fraud in the transaction, that Canton had not negotiated the documents in good faith, and that, in any event, the New York state court injunction relieved Republic of liability for dishonor. Judgment was entered for Canton.

In an extensive and compellingly reasoned opinion, Judge Haight disallowed the objections based on documentary discrepancies that were not timely cured. The court held that, as Republic had failed to sustain its burden of proving fraud, Canton was not required to assume the burden of proving its good faith, saying, "It is not until such fraud is established that the burden shifts to . . . [the] negotiating bank, to establish itself as a holder in due course."[33] Noting that Republic had not opposed the motion for an injunction which, in consequence, had been reflected in the record as granted on consent, Judge Haight held that "the injunction in the State court proceeding does not bar [Canton's] action for damages arising out of [Republic's] wrongful failure to pay under the letter of credit."[34] On appeal, the decision was in all respects affirmed. The Court of Appeals, moreover, expressly characterized the appeal as frivolous and assessed punitive costs against the issuer of the credit.[35]

In the hypothetical case of *Niobe Trust v. Feckless Industries, Inc.*, the facts were as follows: Feckless had a contract to sell and deliver to the Bahrain Bazaar a vast quantity of worry beads. The contract required Feckless to post a performance bond. Accordingly, for account of Feckless, Niobe issued its credit in favor of Bazaar in the amount of $1,000,000, available against Bazaar's sworn statement that the beads had not been "delivered as per contract."

Niobe was prepared to make this commitment on behalf of Feckless because the company was flourishing and the duration of the credit was for only six months. One week after the credit was established, Bazaar drew under it. Feckless commenced an action against Niobe to restrain payment. Feckless asserted that Bazaar's statement, although in the precise form specified by the credit, was incorrect, perjurious, and shamefully fraudulent. Niobe had no knowledge or information sufficient to form a belief as to the accuracy of those assertions. It was mindful of the *Bank of Canton* case and therefore interposed a limp and conclusory objection.

Nevertheless, the injunction was granted. Bazaar thereupon intervened in the action, and moved for summary judgment dissolving the injunction and directing Niobe to pay. The court perceived issues of fact, denied the motion, and set the case down for trial, which was held a year

33. *Id.* at 1318.
34. *Id.* at 1320.
35. 636 F.2d 30, 31 (2d Cir. 1981). An argument that an issuer is not harmed by an injunction against payment will not henceforward be persuasive to a bank unless accompanied by an adequate indemnity bond. Even with such a bond, how does one indemnify against loss of reputation?

later. Bazaar prevailed and Niobe appealed. Some eighteen months thereafter, the appellate court affirmed the judgment against Niobe and the Supreme Court of the United States denied certiorari. Niobe paid Bazaar and demanded reimbursement from Feckless. Feckless, however, had completed its bankruptcy proceedings by that time, having enjoyed for more than two years what Niobe had contemplated as a six-month extension of credit. Niobe was left in tears.[36]

Conclusion

In the adjudication of letter of credit controversies, failure to apply the rules that a letter of credit is to be construed strictly and as an independent contract creates traumatic and unnecessary identity crises. Such failure is a mortal sin. To the extent that different rules are applied in the name of equity, hypocrisy is exalted because the equities of the issuer are disregarded. The sentiment that it is more important to prevent fraud than to encourage the use of letters of credit, however pious that sentiment may be, has no relevance.

The rules identify the device. Unless the letter of credit is "kep' sep'rate," then no matter how courageous the captains, the courts, and the commentators, the device can no more survive without the rule than a fish can survive out of water, even though the air be purest breath of Heaven.

36. See note 35 *supra*.