

# THE EMERGING LAW OF STANDBY LETTERS OF CREDIT AND BANK GUARANTEES

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If there is an underlying theme to this much overdue Symposium on the emerging law of letters of credit, it is Henry Harfield's (Rudyard Kipling's Captain Courageous) "Things should ha' bin kep' sep'rate." The real problem is how to do it, particularly since, as Bernard Wheble points out, in order to jug the hare you must first catch it. The problem with catching this particular hare is that it is too many things to too many people. Consider the following randomly selected quotes from judicial and non-judicial authorities, including Symposium participants:

"In recent years, another distinct use of the letter of credit has emerged, accomplishing results previously obtained by the use of such devices as performance bonds, escrow agreements and various forms of guaranty arrangements. . . . The use of the letter of credit in this capacity is referred to as a "guaranty" or "standby letter of credit."<sup>1</sup>

"Nor is a letter of credit a contract of guaranty or suretyship. A guarantor or surety is often liable after the beneficiary has unsuccessfully sought payment from the issuer's customer, that is, a buyer of goods. Under a letter of credit, however, the issuer becomes bound in the first instance to pay the beneficiary, and the beneficiary may look immediately to the issuer for payment of drafts presented. Again, the beneficiary is not subject to the various technical and nontechnical defenses that a guarantor

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1. *Pastor v. National Republic Bank*, 56 Ill. App. 3d 421, 428-29, 390 N.E.2d 894, 897 (1979).

or surety may set up."<sup>2</sup>

"It would appear to follow that the distinction between standby credit (sic) and first demand guarantees is largely illusory or, perhaps, of a semantic nature."<sup>3</sup>

"A letter of credit always serves as a guaranty. This does not mean that it is a guaranty. A letter of credit is an identical twin to a guaranty, but the fact that two things look alike and may be used for the same purpose and are difficult to distinguish one from the other, does not mean they are the same thing, and does not mean there are not differences, which, however subtle, are of major importance."<sup>4</sup>

Faced with such a definitional quagmire, there is no choice but to place the definitions in their proper context. The contexts of standby and guarantee credit definitions are basically three: transactional, regulatory and adjudicative in the broadest sense, including court adjudication and formal or informal formulation of customary rules.

## I. THE TRANSACTIONAL CONTEXT

### A. *The Commercial Letter of Credit, the Standby Letter of Credit and the Guarantee of Performance*

A commercial or "documentary" letter of credit may be defined as a formal promise by a bank or another party of known solvency to accept and pay, or only to pay, the draft or demand of payment of the beneficiary upon the latter's compliance with the terms of the credit.<sup>5</sup> As a financial intermediary, the bank issuing or confirming a commercial letter of credit performs the service of payment for the seller or supplier of services and of verification of documentary compliance for the buyer, who is the recipient of such goods or services. By contrast, the purposes of the bank's mediation in the standby letter of credit are as varied as the beneficiaries' needs for assurances of payment or reimbursement.<sup>6</sup>

As an assurance of payment against the presentation of specified documents accompanied by a draft or demand for payment, the standby credit can encompass virtually every obligation known to man. As pointed out by Ellinger and Wheble,<sup>7</sup> what characterizes the usage of the standby letter of credit is the likely occurrence of a default because of a failure to perform, as well as poor performance by the bank's customer of the underlying obligation to the beneficiary. This negative antecedent in the standby letter of credit contrasts with the positive antecedent in the commercial

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2. *Dubuque Packing Co. v. Fitzgibbon*, 599 P.2d 440, 441 (Okla. App. 1979).

3. Ellinger, *Standby Letters of Credit*, 6 INT'L BUS. LAW. 604, 622 (1978).

4. Harfield, *Uniform Commercial Code: Symposium Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92, 93 (1963).

5. See 9 B. KOZOLCHYK, LETTERS OF CREDIT, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 5, § 1 (1980) [hereinafter cited as KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA].

6. For an illustrative enumeration, see Ellinger, *supra* note 3, at 612-14. See also Note, *Guaranty Letters of Credit: Problems and Possibilities*, 16 ARIZ. L. REV. 822, 825-29 (1974).

7. See Wheble, "Problem Children"—*Stand-by Letters of Credit and Simple First Demand Guarantees*, 24 ARIZ. L. REV. 301, 304 (1982).

letter of credit. The issuance of a commercial letter of credit is meant to trigger the seller's bargained-for delivery of required or customary documents to the buyer through the banking intermediaries. In fact, one of the first reported instances of use of standby credits revealed the negative antecedent of a buyer's failure to pay directly to his seller.<sup>8</sup> A bank was asked to issue a commercial letter of credit payable upon the presentation of duplicate documents (invoice, bill of lading and insurance policy) accompanied by the seller's demand for payment. Upon inquiry into the reason for payment against duplicate documents, the bank found out that its letter of credit was to be used only if the buyer had not paid the seller directly once the latter had tendered the original set of documents to the buyer. The bank's credit therefore was standing by, awaiting, as it were, the buyer's non-payment to take effect.

Given its negative antecedent, the documents required by a standby credit differ from those required by a commercial letter of credit. As a documentary letter of credit, the assertions in the documents are adaptable to assure payment on any underlying transaction by the mere expedient of requiring assertions of lack of performance or default.<sup>9</sup> These could range from elaborate third party certifications to terse statements by the beneficiary in the form of "simple demands" of payment. Thus, the standby letter of credit must be regarded as a genus which includes all types of documentary assurances of payment or reimbursement, including notably the "tender bond" as well as "performance" and "repayment" guarantees commonly required of large national and international building and services contractors by their clients or financiers.<sup>10</sup>

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8. See B. KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS* 116, 117 (1966) [hereinafter cited as KOZOLCHYK].

9. Much confusion has emerged from resorting to the primary-secondary dichotomy in order to differentiate the commercial letter of credit from the standby credit and, in turn, the standby from the guaranty credit. Courts as well as authors have attempted to deal with these instruments as discreet categories, based upon the primary or secondary nature of liability. See, e.g., Note, *Standby Letters of Credit—True Letters of Credit or Guaranties: Republic National Bank v. Northwest National Bank*, 33 Sw. L.J. 1301, 1303-10 (1980). In this Note, the guarantor is said to be secondarily liable, *id.* at 1306, yet the standby credit is also said to be "in substance a guaranty, but in the form of a letter of credit." *Id.* at 1309. In part the confusion is due to a failure to express what is meant by the terms primary or secondary, susceptible as they are to various legal connotations. A liability can be classed as primary as a result of its place in a sequence of claims (*i.e.*, what debtor must be contacted or sued first?) and also as a result of the debtor's inability to rely on underlying transaction defenses. Thus, the liability of a guarantor of collection of a negotiable instrument, although sequentially secondary to that of the drawer and maker of the instrument, is primary from the standpoint of his inability to raise underlying contract defenses against a holder in due course. See U.C.C. § 3-416(2); 10 A.L.R.4th 897, 902 (1981). It is submitted that the confusion could be obviated by regarding the standby letter of credit that meets the requirements discussed in the principal text as the genus encompassing "guaranty" and "standby" credits, as well as "banking guaranties," regardless of whether the liability is classed as primary or secondary.

10. See UNIFORM RULES FOR CONTRACT GUARANTEES (I.C.C. Pub. 325 1978) [hereinafter cited as I.C.C. RULES] (on file with the *Arizona Law Review*) which describe the purpose of a "tender bond" as providing an assurance of the party submitting the tender (principal) to sign the contract if the tender is accepted; a "performance guarantee" as safeguarding against the party to whom the contract is awarded (principal) failing to meet his obligations under the awarded contract; and a "repayment guarantee" as assuring the party awarding the contract that advances made by him will be repaid in the event of the principal not fulfilling the contract terms. For a synopsis of the drafting process of the I.C.C. Rules until 1974, see Note, *supra* note 6, at 855-59. For a more recent evaluation, especially on the impact of the I.C.C. Rules on English law, see

A standby letter of credit can be drafted so as to incorporate any negative antecedent into its documentary specifications. It can stipulate, for example, payment against a certification of failure to execute the final contract after the award of the bid, or of a failure to perform or to effect repayment of advances or the total amount of the contract. Such variations of the commercial letter of credit do not alter the basis upon which it became one of the most relied-upon trade instruments of our time.

The standby letter of credit, as an offspring of the commercial letter of credit, will continue to be relied upon as long as the financial intermediary continues to provide two distinct assurances. The first is an "abstract" assurance of payment to the beneficiary (seller or provider of services). An abstract promise of payment is one which is independent of the equities in underlying transactions, such as those between the seller or provider and his buyer or client; the bank's customer or account party and the issuing or confirming bank; and between the requesting, issuing, notifying, confirming, negotiating and paying banks.<sup>11</sup> Thus, the beneficiary of an established commercial letter of credit can demand the enforceability of the bank's promise strictly on the terms and conditions specified in the letter of credit, regardless of the inadequacy of consideration in an underlying sale. He can also claim payment regardless of a reimbursement agreement or of insufficiency of collateral between the account party and the issuing or confirming bank, or of mistaken or inconclusive communications between the issuing, notifying, confirming, negotiating and paying banks.

The second essential assurance is that the banks involved in the commercial letter of credit transaction will use their professional skill and integrity in verifying that the beneficiary complied with the terms and conditions of the credit instrument. The party interested in this assurance is the bank's customer or account party. Clearly these assurances can be made available to both the beneficiary and customer of a standby letter of credit. For this reason, no objections can be raised to the 1977 opinion of the International Chamber of Commerce Commission on Banking Technique and Practice<sup>12</sup> that standby credits fall within the definition of documentary credits provided in paragraph (b) of the general provisions and definitions of the Uniform Customs and Practice for Documentary Credits (U.C.P.).

The issuing or confirming bank ceases to act in its professional banking capacity, however, when it undertakes in a standby credit to ascertain the occurrence of acts or events of default by its customer or by third parties.<sup>13</sup> The distinction between acting as a commercial banker and as a "dealer" in goods, whatever their nature and volume, was taught vividly to two generations of letter of credit bankers by First National City Bank's

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White, *Bankers Guarantees and The Problem of Unfair Calling*, 11 J. MAR. L. & COM. 121, 129-31 (1979).

11. For a discussion of the abstraction principle and its meaning in standby letter of credit law, see text & notes 238-40 *infra*.

12. See DECISIONS (1975-1979) OF THE ICC BANKING COMMISSION ON QUERIES RELATING TO UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS 11 (I.C.C. Pub. 371, 1980).

13. *But cf.* *Edward Owen Eng'r Ltd. v. Barclays Bank Int'l Ltd.*, [1978] 1 Lloyd's L.R. 166; *Harbottle (R.D.) (Mercantile) Ltd. v. National Westminster Bank Ltd.*, [1977] 3 W.L.R. 752.

Frank Sauter with the following illustration: a customer wants the bank to issue a letter of credit predicated upon the bank's ascertaining that the olive oil shipped by the beneficiary is as found in a sample bottle provided to the bank. Sauter suggested that:

Of course we could have accommodated him if we wanted to, but experience has taught us to mind our own business, and that is the banking business. . . . No bank that knows the commercial credit business would enter into a transaction of this kind just to accommodate even its best customer. It would be impractical for a bank to do so anyhow when you stop to think about it.<sup>14</sup>

The U.C.P. reflects the international banking community's endorsement of separation between the bank's and the customer's business when they declare, proverbially, that banks deal in documents and not in goods.<sup>15</sup>

In verifying the beneficiary's compliance with the terms and conditions of the commercial letter of credit, the bank is protected by standards of diligence that take into account that which is known in the banking trade about documents emanating from other trades. This knowledge is restricted only to some effects of those documents. Thus a bank is supposed to know what is a marine "on board" as opposed to a "received for shipment" bill of lading. But an issuing banker is not expected to know whether the bill of lading in question is in full conformity with the laws of the country in which it was issued. What the commercial letter of credit banker is supposed to know is objectively ascertainable by referring to the written banking customs such as found in the U.C.P. and the unwritten rules as to what experienced bankers would have done under the circumstances. In addition, a standby letter of credit banker should be held responsible for distinguishing between a document clearly labelled "bid" and one labelled "contract" or between one labelled "release of contractual liability" and one labelled "lien waiver." He cannot, however, be held responsible for the knowledge and skills peculiar to each of the numerous underlying trades or professions. Accordingly, a bank departs from sound commercial letter of credit practice when it issues a performance guarantee in the manner described in the International Chamber of Commerce Uniform Rules for Contract Guarantees (I.C.C. Rules).<sup>16</sup> Upon proof of non-performance, the beneficiary will be entitled to demand either a stipulated sum of money or a completed performance of the contract.<sup>17</sup> Even if the bank is willing to act on the basis of the expert advice of consulting contractors, engineers, architects, or nuclear scientists, it must be prepared to

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14. 2 F. Sauter, *Random Notes on Commercial Credits* 44-45 (1963) (internal publication of First National City Bank).

15. See *UNIFORM CUSTOMS AND PRACTICES FOR DOCUMENTARY CREDITS* art. 8(a), (I.C.C. Pub. 290, 1974) [hereinafter cited as U.C.P.].

16. Article 2(b) of the I.C.C. RULES, note 10 *supra*, describes a "performance guarantee" as an undertaking given by a bank, insurance company or other party (the guarantor) at the request of a supplier of goods or services or other contractor (the principal) . . . whereby the guarantor undertakes that in the event of default by the principal in due performance of the terms of the contract between the principal and the beneficiary to make payment . . . or . . . at the guarantor's option, to arrange for performance of the contract.

17. I.C.C. RULES, *supra* note 10, at art. 2(b).

face the consequences of their negligence or the validity of contrary opinions. Therefore, the bank guaranteeing performance as such (as contrasted with a guarantee of payment) is exposed to significant liability both at the time of determination of performance and when deciding to undertake the completion of performance. If it chooses to complete performance instead of paying the beneficiary, it cannot ignore the likelihood of additional liabilities to injured workmen, tenants or passersby, unpaid tax authorities, and so on.

## B. *Types of Standbys*

### 1. *According to Type of Bank*

A recent study and a survey by P. Lloyd-Davies of the Research Staff of the Board of Governors of the Federal Reserve Board<sup>18</sup> shed light on the types of banks that issue standby credits and on their most common uses. Predictably, large banks are the most extensive issuers. Banks with assets of over 1 billion dollars account for more than 90% of the total standby letters of credit outstanding in terms of amount of money issued.<sup>19</sup> Of these banks, the First National City Bank of New York (Citibank) accounts for about twenty-five percent of the total of approximately thirty-five billion dollars issued in the first three months of 1980.<sup>20</sup> But while large banks account for the largest percentage of standbys in terms of the amount of money issued, over one-half of all the banks issuing these credits have less than fifty million dollars in total assets. This fact prompts Lloyd-Davies' conclusion that standbys "have the potential to cause problems for small banks as well as large ones."<sup>21</sup>

The Lloyd-Davies study lists three reasons for the dominant presence of large multinational banks in the standby issuing business. The first is that beneficiaries are most apt to rely on a standby issued by a large bank than by a smaller one. The second is the expertise developed by large banks with regard to commercial letters of credit, an expertise not generally available in smaller banks. Finally, since the issuance of standbys frequently involves very large amounts, especially in connection with construction projects, only large banks have the sufficient resources to issue such credits without violating their lending limits to the specific customer-borrower.<sup>22</sup>

An unmentioned, but in this writer's opinion equally significant, cause of the dominance of large multinational banks is their wider network of correspondent relations, including foreign and domestic branches and subsidiaries. Unlike sureties of different nationalities and places of business,

18. Lloyd-Davies, *Survey of Standby Letters of Credit*, 65 FED. RES. BULL. 716 (Sept. 1979) [hereinafter cited as *Survey*]; P. Lloyd-Davies, *Standby Letters of Credit of Commercial Banks*, 113 Staff Studies, in *Below the Bottom Line: the Use of Contingencies and Commitments by Commercial Banks* 17 (Jan. 1982) (Board of Governors of the Federal Reserve System) [hereinafter cited as *Study*]. The author is grateful to Michael A. Goldberg, Esq. of the Federal Reserve legal staff for making the study available as soon as published.

19. See *Study*, *supra* note 18, at 34-39.

20. See *id.* at 35 (Table 1) & 37 (Table 2 with list of largest issuers).

21. See *id.* at 36.

22. See *id.*

correspondent banks communicate with each other rapidly, easily, inexpensively and in a binding manner. They also have a much wider pool of information on customers, beneficiaries and corresponding banks than do smaller banks. Chances are that a given customer requesting a large issuance will be better known to them than he will be to smaller banks and surety companies. Communications between correspondent banks use uniform terminology, and their legal instruments are frequently accorded similar legal effects in different jurisdictions. Further, correspondent banks often enjoy lines of credit with different "facilities" which include discounts of commercial paper and overdrafts. Transactions are routinely assigned to the appropriate facility and the accounts are credited or debited with consensually binding effects upon both parties.<sup>23</sup> Thus, correspondent banks are able to transact business and to assume, pay, charge and collect liabilities worth billions of dollars with a minimum of formality and legal expense. When the ease, rapidity, binding effect and economy of their communications are added to the ability to rely on their combined financial resources and to charge lower fees than sureties or bonding companies, it becomes apparent why large banks have taken over, internationally and nationally, a substantial segment of the suretyship and bonding business.

## 2. According to Type of Use

The most significant use of standbys issued to foreign beneficiaries is in connection with construction projects.<sup>24</sup> Of the eleven billion standbys supporting transactions abroad at the time of a survey in the spring of 1979, approximately one-half were issued in connection with construction projects.<sup>25</sup> In this type of standby, the foreign correspondent is sometimes asked to issue its own standby and to seek reimbursement from the balances of the U.S. bank in its account with the foreign correspondent. On other occasions the U.S. bank is required to issue a "counterguarantee," which consists of the U.S. bank's own standby credit payable upon presentation of documents indicating payment of its standby by the foreign correspondent.<sup>26</sup>

By contrast, approximately seventy-five percent of standby credits supporting U.S. domestic transactions were used in connection with what the Lloyd-Davies study describes as "financial" transactions,<sup>27</sup> particularly among the largest banks. The study refers to a financial transaction as meaning one in which the issuing bank assures the beneficiary that he will receive payment for his financing of the bank's customer's borrowing. For example, one such assurance is that of payment of the commercial paper

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23. On correspondent banking relations, viewed from a banking standpoint, see P.J. OPPENHEIM, *INTERNATIONAL BANKING* 37-51 (3d ed. 1978); from a legal standpoint, see J. WHITE, *BANKING LAW* 916-18 (1976).

24. See Study, *supra* note 18, at 36 & 40 (Table 5); Survey, *supra* note 18, at 109.

25. See Study, *supra* note 18, at 36 & 40 (Table 5); Survey, *supra* note 18, at 109.

26. Another substantial amount of "non-financial" international standbys assures the delivery of merchandise or reimbursement to a foreign bank which undertook to pay letters of credit that deviate in some respect from the terms of the credit. See Study, *supra* note 18, at 40 (Table 5).

27. *Id.* at 36.

such as promissory notes or accepted drafts issued by the customer, an assurance without which the customer could not have borrowed in the commercial paper market. The beneficiary of the financial standby is the holder of the customer's commercial paper or a trustee representing all the holders of such paper. The issuing bank's payment is due upon presentation of the commercial paper with a statement or document indicating its nonpayment at maturity.<sup>28</sup> A significant reason for the popularity of financial standbys with customers and issuing banks alike is that they have often served as means to circumvent costly regulations such as Regulation Q on interest ceilings.<sup>29</sup> If, for example, the rise of interest rates made it harder to attract deposits and grant loans, banks were able to meet their customers' credit needs by the issuance of standbys that would allow prior customers' borrowing in the open market or from other lenders unaffected by the interest rate ceilings. Similarly, reserve requirements were circumvented throughout the 1960's by "documented notes" or notes accompanied by a standby commitment of the banks' holding companies promising payment of their member banks' unpaid notes at maturity.<sup>30</sup> Until 1970, the proceeds procured by the banks through these notes were deemed non-reservable funds by regulatory authorities.<sup>31</sup> And while in 1970 they were deemed reservable deposits, shortly thereafter the member banks began issuing standby credits on behalf of their customers to allow them to borrow in the commercial paper market. The standby issuance prevented the need to put up the required reserves, as the loan funds were not channeled through the banks as deposits.<sup>32</sup>

There is no doubt that the difference between non-financial and financial issuances is significant. A bank that assumes the liability to pay upon the presentation of, say, a certificate of inspection stating that the bridge built or merchandise shipped by its account party is defective does not assume the same debt as when it promises to pay upon the presentation of a draft drawn against its branch as a result of the latter's borrowing in the commercial paper market. In the case of payment against the certificate of inspection, the unreimbursed issuing bank has, in effect, lent its money to its customer (shipper or builder), whereas in the case of payment against presentation of the draft, it paid for what was the bank's own borrowing. This situation is fraught with peril, particularly when it disguises the true borrower behind "dummy" corporations.<sup>33</sup> The differences be-

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28. A variant of the financial standby popular with financiers of the credit-starved construction industry is the so-called "standby loan commitment." This standby assures the short-term construction lender that upon expiration of the loan period, the issuer will pay the construction loan if the borrower is unable to do so. Other variants assure payment of obligations of brokers of future contracts to their customers, payment of margin deposits, value of stock in securities' options, and so on.

29. See Study, *supra* note 18, at 26-28. For a decision involving an allegation of an avoidance of a state usury ceiling, see *Bank of N.C. v. Rock Island Bank*, 630 F.2d 1243, 1246-47 (7th Cir. 1980).

30. Study, *supra* note 18, at 28.

31. *Id.*

32. *Id.*

33. See generally, Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 TUL. L. REV. 314, 315 (1979).



tween these uses, then, must be taken into account by bank and governmental officers concerned with the safety and soundness of banking practices, and is reflected in rules governing lending limits and collateralization.<sup>34</sup> Yet from the standpoint of the risk of unreimbursed payments, the non-financial standby can be as risky as its financial counterpart. Take, for example, the same landmark decision discussed by Wheble, *American Bell International v. Islamic Republic of Iran*.<sup>35</sup> A large American company, American Bell International, requested a large seaboard bank in the United States to issue a standby credit guaranteeing its performance of a construction contract in the Shah's Iran. The Iranian government required a local bank, also the United States bank correspondent, to issue the operative letter of credit. As a condition for its issuance, the Iranian bank requested from the United States bank a standby credit "counter-guaranteeing" its own credit to the Iranian government. The standby credit issued by the United States bank was payable upon "simple demand."

When the American Bell International standby credit was issued, the issuing bank's and its customer's assumption was that the then Iranian ruler (or his kind of rule) was to remain in power for a long time.<sup>36</sup> Yet, with changes in ruling groups come changes in contractual relations with the outside world and, not infrequently, demands for payment of standbys on bases justifiably deemed fraudulent by the foreign contractor. In *American Bell International*, the U.S. contractor's resort to the equitable remedy of an injunction in the United States against the U.S. bank's payment to its correspondent caused the bank hardships vividly described by the United States District Court of New York as follows:

To be sure, Bell faces substantial hardships upon denial of its motion [seeking to enjoin the issuing bank's payment of the credit to the revolutionary government of Iran or to its correspondent bank in Iran]. . . .

But Manufacturers [the U.S. issuing bank] would face at least as great a loss, and perhaps a greater one, were we to grant relief. Upon Manufacturers' failure to pay, Bank Iranshahr could initiate a suit on the Letter of Credit and attach \$30.2 million of Manufacturers' assets in Iran. In addition, it could seek to hold Manufacturers liable for consequential damages beyond that sum resulting from the failure to make timely payment. Finally, there is no guarantee that Bank Iranshahr or the government, in retaliation for Manufacturers' recalcitrance, will not nationalize additional Manufacturers' assets in Iran in amounts which counsel, at oral argument, represented to be far in

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34. See text & notes 55-97 *infra*.

35. 474 F. Supp. 420 (S.D.N.Y. 1979).

36. This assumption, incidentally, accounts in considerable measure for what Wheble labels as the "less formal" definition of a standby (and implicitly simple demand) credit: "It is a letter of credit your customer brings to you, stating 'don't worry what it says, it will never be drawn against.'" Wheble, *supra* note 7, at 302. This assumption is also present in Lloyd-Davies' description of these standbys as prompting an issuance which "may be little more than a pro forma step to satisfy the requirements of the government of the country where the project is located." *Survey*, *supra* note 18, at 109.

excess of the amount in controversy here.<sup>37</sup>

Thus, the availability of correspondent relations with Iran on the one hand allowed Manufacturers to become involved in what appeared at first sight as a safe and lucrative transaction, but on the other hand, limited its options by increasing its exposure. The ever-present risk of unreimbursed payments, in non-financial and financial standbys alike, makes proper collateralization a central regulatory concern. This issue will be further discussed in the following section.

The Lloyd-Davies survey reports a utilization of collateral by large banks amounting, on average, to eighteen percent of the value of the standby, whereas the percentage for smaller banks was thirty-eight percent.<sup>38</sup> Mr. Lloyd-Davies attributes the disparity in these averages to the greater likelihood of payments or "takedowns" in the standbys issued by the smaller banks.<sup>39</sup> A sharp disparity, however, was left unexplained in the Lloyd-Davies survey and study. This disparity arises in the collateralization of non-financial standbys issued to foreign and U.S. beneficiaries. The ratio of large bank collateralization in connection with insuring contract performance associated with construction projects to U.S. beneficiaries was approximately \$1 of collateral to \$30 issued, whereas when issued to foreign beneficiaries the ratio was approximately \$1 to \$4.50.<sup>40</sup> Since the definition of collateral used by the survey included only "marketable securities, readily marketable commodities and guarantees or standby letters of credit issued by the government, insurance companies or other banks,"<sup>41</sup> and did not include balances in the customer's or correspondent's accounts, it may be hypothesized that these balances are being relied upon by large banks as "de facto" collateral when issuing or confirming standbys. The issuance of a standby by a large bank to a U.S. beneficiary can be requested by a bank's local customer, usually a substantial enough depositor to prompt a thinly-collateralized issuance. It is also frequently requested by a foreign correspondent bank with sufficient balances in its account so as to allow the placement of a "hold" ticket or notation on the appropriate amount of the balance once the standby liability ceases to be contingent.<sup>42</sup> In both instances account balances can be used as "de facto" or non-identified collateral until the moment of effec-

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37. 474 F. Supp. at 426.

38. *Survey*, *supra* note 18, at 108-09.

39. *Id.*

40. *Id.* By contrast, the disparity in smaller bank collateralization of the same type of issuances was considerably smaller: approximately \$1 of collateral to \$3 issued in the case of U.S. beneficiaries, and \$1 of collateral to \$5 issued in the case of non-U.S. beneficiaries.

41. *See id.* at 108 n.6.

42. A typical "hold-ticket" procedure, which was introduced in evidence as stipulated in *Bank of America v. United States*, 81-1 U.S. Tax Cas. (CCH) ¶ 9161, 47 A.F.T.R. 2d 81-652 (P-H) (Ct. Cl. Jan. 28, 1981), is described in the Bank of America's Negotiator's Guide, Export Letter of Credit, 1403:

The bank, before paying an unconfirmed credit and or releasing documents under confirmed credit must be certain that the funds to cover the payment are in the bank. The ticket examiner, in placing the hold, assures this, and if a hold is considered good, those funds are reserved to cover the relative payment. Should the hold evidence insufficient funds to cover the payment, the overdraft sheet (CR-117) is then prepared by the operating section, in this case, the Letter of Credit Section.

tive, as distinguished from contingent, liability. Smaller banks generally do not have access to such healthy balances, which could explain the much higher rates of collateralization for the same issuances. Yet, as shown by the *American Bell International* proof of hardship analysis, when the balances are those of a foreign correspondent bank, the collateralization value could well be minimal. Any debiting in the United States would be more than matched by the foreign debiting, attachment, expropriation or confiscation of the U.S. bank's assets.

### 3. *According to Method and Documentation of Payment*

Banks can issue, notify or confirm another bank's issuance of a standby credit much as they do commercial letters of credit. Standby letters of credit, however, are invariably issued as irrevocable promises of payment, since revocable standbys could not be regarded as reliable assurances of payment. Nevertheless, given the unpredictability of commercial ingenuity, revocable standbys could appear in practice. By the same token, while standbys are most effective assurances when payable at sight, time or acceptance standbys are conceivable and nothing in theory prevents their use.

Standbys are usually payable not against the customary documents in a sale of goods transaction, but against documents that evidence either the beneficiary's performance or the customer's default in the underlying transaction. Significantly, even when the bank's payment is against a document indicating the beneficiary's performance, the standby presupposes a negative antecedent, that is, the customer's lack of payment in the underlying transaction. The operative document that triggers payment varies significantly from credit to credit and can be classified only in accordance with the nature of the issuer and whether or not it purports to prove or certify anything.

The document may be issued by the beneficiary himself, by a third party, or by both the beneficiary and a third party or parties. Documents issued by the beneficiary or by third parties can function as purported evidence of the occurrence or non-occurrence of an act or event, or as formal certifications that the terms and conditions specified in the operative instrument have been met. The less assertive the document is in terms of the occurrence of an act or event, the less is the need for the bank's scrutiny. A failure to supply, say, building materials according to underlying contract specifications in a certificate of inspection is bound to contain more troublesome terms and assertions than is a mere statement by the beneficiary that "the failure described in the letter of credit has taken place." And when the required document is the "simple demand" type of guarantee, or is one in which the beneficiary only expresses his demand for payment without need of proof of the occurrence of any act or event or certification of the existence of the conditions for payment, the bank's scrutiny is limited to establishing the authenticity of the beneficiary's signature or his identity. By contrast with other types of documentation, the beneficiary in a simple demand type of credit makes no representations to the bank and is therefore immune from the issuing, confirming, or paying bank's actions

for misrepresentation or for unjust enrichment as a result of a mistaken payment, except for the warranties of genuineness of his signature and accuracy of his identification. Undoubtedly, all these reasons must have weighed heavily in the decision not to include simple demand guarantees in the I.C.C. Rules.<sup>43</sup>

Simple demand standby credits are as objectionable as simple demand guarantees. A simple demand beneficiary implicitly rejects the bank's role as the issuer of the basic assurances to both parties and transforms the bank into a pliant custodian of funds which can become the beneficiary's at his discretion. Here, then, lies a key distinction from the so-called "clean" or non-documentary commercial letter of credit, or a letter of credit payable simply against the beneficiary's draft. When a customer agrees to a clean commercial letter of credit, it is not as a result of the beneficiary's imposition but of the customer's own convenience. Since their inception these credits have been issued, as Karl Llewellyn reported,<sup>44</sup> in anticipation of consignment shipments or where the beneficiary was the customer's trusted agent for the purchase of merchandise. By contrast, for example, the Libyan Government bank's status as a beneficiary of the simple demand credit objected to by the German Banker's Association<sup>45</sup> entitled it to payment even in the face of a court of appropriate jurisdiction's injunction against payment.<sup>46</sup> The Libyan bank's disregard for the issuing bank's role as a trusted intermediary and for the function of courts in pluralistic legal systems is characteristic of a contemporary Persian Gulf version of the Golden Rule: "He who has the black gold, rules."<sup>47</sup> Predictably, however, as more and more account parties become the victims of beneficiary arbitrariness, the simple demand standby will be rejected by all but the neediest, silliest or greediest of account parties.

### *Summary and Conclusions*

Standby letters of credit are an outgrowth of commercial letters of credit practices. As such, they rely on the issuing bank's assurances to ben-

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43. I.C.C. RULES, *supra* note 10, at 8-9:

In drafting these Rules care has been taken to maintain the maximum possible flexibility consistent with observing the concepts referred to above, and also, by establishing the principle of the need to justify a claim under a guarantee, to invest guarantee practice with a moral content. Thereby it is hoped that international trade conducted on the basis of contract guarantees may develop in an atmosphere of confidence.

For the said reasons it has not been found advisable to make provision for so-called simple or first demand guarantees, under which claims are payable without independent evidence of their validity.

44. See Llewellyn's commentary in H. HARFIELD, BANKS, CREDIT AND ACCEPTANCES 159-60 (1974) [hereinafter cited as H. HARFIELD].

45. See Wheble, *supra* note 7, at 308.

46. As stated by Lord Denning with his customary flair: "So here it is. The long and the short of it is that although *prima facie* the Libyan customers were in default in not providing the letter of credit, nevertheless they appear to have claimed against Umma Bank on the performance bond issue by them . . ." *Owen v. Barclays Bank*, [1978] 1 Lloyd's L.R. 170. Despite the obvious injustice, Lord Denning held, however, that "a bank which gives a performance guarantee must honour that guarantee according to its terms." *Id.* at 171.

47. The principal text's version of the Golden Rule is a slight modification of that provided by Henry Harfield, Esq. to the "Letter of Credit Litigation" Seminar at the University of Arizona College of Law on March 5, 1981.

eficiary and customer: the former is assured of payment strictly in accordance with the terms of the operative instrument and independently of underlying contract considerations, and the latter is assured a careful and honest verification of compliance with the credit terms. Banks are only equipped to safely handle assurances of payment and not of completion of performance of underlying obligations. Not only do they lack the necessary expertise, but once the banks undertake the assurance of completion of performance they cannot escape the liability inherent in the innumerable trades or professions involved in such assurances.

As a documentary promise of payment, the standby letter of credit is a genus that encompasses any assurance of performance that can be reduced to a documented monetary claim, including those found in the traditional tender bonds and guarantees of performance and repayment. The advisability of true documentary issuances, as opposed to the purely perfunctory or nonexistent documentation in simple demand standbys, stems from the desirability of preserving the bank's role as a trusted financial intermediary and the undesirability of transforming the bank, while ostensibly the party issuing a letter of credit, into a mere custodian of a beneficiary's "discretionary" funds. The context of the bank's activity and role is crucial. Nothing, of course, should prevent the bank from acting as a mere custodian of funds for the beneficiary if that is what the parties truly agree upon. But then, a letter of credit should not be the means with which to effect the custody, for it connotes trustworthy intermediation and distinct assurances of honest payment and verification of terms to both parties.

Standby credits usually are issued, mostly by large banks, for the assurance of payment in connection with defaults in large construction projects, although a significant amount of strictly "financial" issuance is still observable. Among the various factors that encourage resort to large banks is their ability to rely on a wide network of correspondents and on their reciprocal accounts. Yet reliance on such accounts as *de facto* collateral for the issuance of confirmation of standbys exposes the issuing or confirming bank to considerable risks. The prevention of the banking risks attendant upon the issuance and confirmation of standbys, a regulatory concern, will be discussed in the following section.

## II. THE REGULATORY CONTEXT

### A. *Scope and Purpose of Commercial Letter of Credit Regulation*

Since the appearance of commercial letters of credit in the second half of the nineteenth century, banking regulation has been concerned mainly with the effects that letters of credit and acceptances have upon banks' solvency and liquidity. The issuance of commercial letters of credit *per se* is not subject to limitations. The regulatory theory has been that even in the case of irrevocable credits, issuance by itself does not threaten the bank's solvency or liquidity of assets, as it is a liability contingent upon the beneficiary's compliance with the credit terms.<sup>48</sup> Once the liability ceases

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48. See FED. RES. BULL. 816 (1921); H. HARFIELD, *supra* note 44 at 267-69.

to be contingent, however, as when the bank accepts the beneficiary's draft or agrees to pay a sight draft or demand for payment, quantitative and qualitative limits are imposed on the bank's lending and borrowing powers.<sup>49</sup> The National Banking Act of 1864 and a majority of state banking statutes limited the amount that banks could lend to their customers to ten percent of the bank's unimpaired paid-in capital and surplus.<sup>50</sup> This is the so-called per customer lending limit of 12 U.S.C. § 84. Similarly, 12 U.S.C. § 82 limited the aggregate liabilities that banks could undertake to 100% of their paid-in capital plus 50% of their unimpaired surplus.<sup>51</sup> This is the so-called "borrowing limit" which, as pointed out by Henry Harfield, is not applicable to banks chartered under state law, and some jurisdictions, such as New York, have accordingly refrained from imposing such a limit.<sup>52</sup>

The nature of the exceptions to these limitations reveals the nature of regulatory concern. For example, acceptances eligible for discount with a Federal Reserve Bank (which are known as eligible acceptances) qualify as exceptions to the per customer section 84 lending limit and to the banks' section 82 borrowing limit, if they grow out of letters of credit financing the import or export of agricultural commodities and are secured by warehouse receipts with a maturity of no more than six months.<sup>53</sup> Similarly exempt are other highly collateralized acceptances.<sup>54</sup>

What concerned the legislator, then, was that the commercial banks involved in the issuance of letters of credit, not pay, nor be bound to pay, without a credible promise of reimbursement effective within a short period of the time of the issuance of the credit.

### B. *The Regulation of Standbys*

The regulatory policy concerning standbys has been, on the whole, consistent with that of commercial letters of credit. Unless characterized as an ultra vires guarantee or suretyship promise, standbys are deemed to be within the implied powers of banking issuance.<sup>55</sup> Unlike commercial letters of credit, however, their mere issuance has been found to pose risks to the banks' solvency and liquidity. Thus, since 1974, federal regulatory agencies have required banks under their jurisdiction to count standbys toward each customer's section 84 lending limits and to disclose their issu-

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49. H. HARFIELD, *supra* note 44, at 267-69.

50. 12 U.S.C. § 84(1) (1976). As an example of a state statute inspired by the above provision, see CAL. FIN. CODE § 1224 (1968 & Supp. 1981) (as amended in 1978).

51. 12 U.S.C. § 82 (1976). For an instructive commentary on this provision, see H. HARFIELD, *supra* note 44, at 267-68.

52. H. HARFIELD, *supra* note 44, at 267-68.

53. *Id.* at 128-38.

54. *Id.*

55. See *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1224, 1229 (5th Cir. 1973), *cert. denied*, 414 U.S. 1139 (1974); *Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109, 116 (Tex. 1978). Following the *Barclays Bank* case, the various federal regulatory agencies expressly upheld the issuance of standbys by banks. See, e.g., Federal Deposit Insurance Corporation Regulations, 12 C.F.R. § 337.2 (1981) (effective Aug. 14, 1974); Comptroller of the Currency's Interpretive Ruling, 12 C.F.R. § 7.1160 (1981) (effective Aug. 13, 1974); Federal Reserve Board Conditions of Membership of State Banks, 12 C.F.R. § 208.8(d) (1981) (effective Feb. 13, 1974).

ance in footnotes to the bank's balance sheet.<sup>56</sup> The issuance of standbys is not counted, however, as a bank borrowing or assumption of liability under section 82 aggregate assumption of liability limits.<sup>57</sup> Moreover, the standby issuance was exempted from section 84 per customer lending limits when the issuance was prepaid, or when the issuing bank had set aside sufficient funds in a segregated deposit account clearly earmarked to cover the bank's maximum liability under the credit.<sup>58</sup> The issuance was also exempted when the Comptroller of the Currency had found that a given standby credit or class of standbys did not expose the issuing bank to the same risk of loss as would a loan to the customer.<sup>59</sup>

These restrictions upon the issuance of standbys were in large measure the result of the failure of the United States National Bank in San Diego. The bank failed after issuing approximately ninety million dollars in standby credits, of which a significant amount guaranteed payments of loans to companies or dummy corporations controlled by a principal stockholder of the bank.<sup>60</sup>

The subjection of standby credits to the per customer lending limits made it necessary to distinguish them from commercial letters of credit which, as indicated earlier, ordinarily are not subject to such limits. Interpretive Ruling 7.1160 from the Office of the Comptroller attempted to make this distinction, with dubious results. A standby credit was defined as:

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 to or 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 payment on account of any default by the account party in the performance of an obligation.<sup>61</sup>

In a footnote to this definition, the Ruling stated that a standby does not include commercial letters of credit, or similar instruments where "the issuing bank expects the beneficiary to draw upon the issuer, which do not 'guaranty' payment of a money obligation and which do not provide payment in the event of default by the account party."<sup>62</sup>

The problem with the above definition and distinction is their imprecision: many a commercial letter of credit could qualify under sections (1)

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56. 12 C.F.R. § 208.8(d) (1981); 12 C.F.R. § 337.2 (1981); 12 C.F.R. § 7.1160 (1981). See also Verkuil, *supra* note 33, at 319.

57. 12 C.F.R. § 208.8(d) (1981); 12 C.F.R. § 337.2 (1981); 12 C.F.R. § 7.1160 (1981). Verkuil states that after the "phenomenal" growth in 1973-74 of standbys (\$6 billion outstanding in December 1973, \$9 billion in June 1974), Senator Brooke introduced a bill in August 1974 subjecting standbys to the total liability limits. Such a restriction was not enacted. Verkuil, *supra* note 33, at 319.

58. See Ruling 7.1160, note 55 *supra*.

59. *Id.*

60. See *Failure of the U.S.N. Bank of San Diego: Hearings before the Subcomm. on Bank Supervision and Insurance of the House Comm. on Banking and Currency*, 93d Cong. 1st Sess. 37 (1973). On the role played by the failure of the U.S. National Bank of San Diego in the regulatory process, see Verkuil, *supra* note 33, at 315.

61. Ruling 7.1160, note 55 *supra*.

62. *Id.* at 60 n.1.

and (2) of the definition of standbys and, as discussed earlier, most standbys should be issued with the expectation that they will be drawn upon by the beneficiary, thereby qualifying them for the footnote definition of a commercial letter of credit. In light of the earlier discussion on the transactional context of standby credits, it would seem that administrators would be better served by a distinction predicated upon the nature of the documentary presentation in a standby. A documentary presentation which does not intend to convey title to shipped goods or to supply evidence of their insurance or transportation, but rather intends to establish that a certain act or event related to the performance or default of an underlying transaction has taken place, should be treated as part of a standby credit.<sup>63</sup>

The transactional context should also serve as a warning as to the correct method of interpreting the exceptions to the collateralization requirement of standbys in the Comptroller's Interpretive Ruling 7.1160. It will be recalled that when an issuing bank is "paid prior to the time of issuance of the standby an amount equal to the bank's maximum liability under the standby letter of credit," such a standby is not subject to the per customer lending limits of section 84. Given the uncertainties inherent in regarding balances in correspondent banks' accounts as de facto collateral,<sup>64</sup> it would be unwarranted and risky to interpret the above-quoted language as requiring anything less than full prepayment of the issuance. In other words, the mere fact that at the time of requesting the issuance of a standby the correspondent bank has a sufficient balance in its U.S. account to cover the issuance should not qualify such an issuance as a pre-paid one. The balance may disappear shortly thereafter as a result of a

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63. The proposed criterion is implicit in the Comptroller of the Currency's Interpretive Ruling 7.7016(d) of May, 1977: "the bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law . . . ." See Comptroller of the Currency's Interpretive Ruling, 12 C.F.R. § 7.7016 (1981) (effective May 12, 1977). The same approach was advocated by this author in 1966. See KOZOLCHYK, *supra* note 8, at 633, 634. Among the additional restrictions considered by Congress in the early seventies were: (1) to make standbys subject to reserve requirements; (2) to count them toward the aggregate borrowing limits, considering the issuance itself a borrowing; (3) to include them among the extensions of credit to single individuals and to extend the per customer lending limit to state member banks as well; (4) when determining the per customer lending limit to include all the obligations of dummy corporations, which are set up to appear as leasing property to the actual user of the credit; and (5) to require full disclosure in the main body of the bank's balance sheet. For an insightful analysis of these proposals and the reasons for their rejection, see Study, *supra* note 18, at 49-54. Since Congress requested the Survey in order to determine the advisability of additional regulation, the Survey's conclusions were highly influential given subsequent congressional inaction. The Survey stated that:

[A]lthough standby letters of credit have the same risk potential as a direct loan of funds, in practice they result in much lower losses. Takedowns are fairly rare, but more important the amounts disbursed are almost always recovered promptly by the bank from its customer. The bank may facilitate this recovery by requiring its customers to post collateral . . . . The survey found no obviously imprudent uses of the instrument, and consequently no additional regulation or legislation was recommended.

Survey, *supra* note 18, at 107. For arguments in favor of and against further regulation, see Arnold & Brandsilver, *The Standby Letter of Credit, The Controversy Continues*, 10 U.C.C. L.J. 272 (1978); Harfield, *The Standby Letter of Credit Debate*, 94 BANKING L.J. 293 (1977); Katskee, *The Standby Letter of Credit Debate—the Case for Congressional Resolution*, 92 BANKING L.J. 697 (1975); Verkuil, *supra* note 33, at 319.

64. See text & notes 40-42 *supra*.



preexisting yet undebited transaction, or may become subject to a counter-vailing debit abroad. Given the inherent risks, earmarking or identification of the funds as having been prepaid or segregated in connection with the issuance seems the only plausible interpretation of the exception in question.

### C. Collateralization and Bankruptcy Law

Given the central role of collateralization in the avoidance of standby issuance risk, it is important to note some recent developments that cast a shadow on the issuing bank's security on the insolvent customer's collateral and on the abstraction of the bank's obligation to the beneficiary. According to *Twist Cap, Inc. v. Southeast Bank*,<sup>65</sup> a 1979 decision by the Bankruptcy Court for the District of Florida, the debtor-customer's provision of sufficient security to induce the issuance of a letter of credit warranted the characterization of the letter of credit as the insolvent debtor's property. This finding led to the issuance of an injunction against the bank's payment to the beneficiary who was regarded as an unsecured creditor receiving preferential treatment.<sup>66</sup> Attention must be focused, then, on the legal nature of the bank's rights to the collateral most frequently provided to banks.<sup>67</sup>

If the collateral provided by the customer is cash, the transaction may be regarded as a total or partial prepayment, or as the creation of a blocked or segregated fund or account to assure the bank's reimbursement in the event of payment of the credit.<sup>68</sup> The delivery of money to effect a prepayment of the issuance conveys title to the money prepaid even if the issuance does not take place or the beneficiary fails to comply with the terms of the credit. As part of a current account relationship, the customer's deposit of money with the issuing bank in common law terms allows the bank to treat the money "as his own, like any other borrower; (as) the customer has parted with control over it, like any other lender, retaining only his right to repayment."<sup>69</sup> Prepaid amounts deposited with large U.S. banks are segregated into separate control accounts, and interest is paid on them to their customers.<sup>70</sup> Since U.C.C. section 9-104 specifically excludes from article 9 "a transfer of an interest in any deposit account . . ."<sup>71</sup> and deposit account is defined by section 9-105(e) as any "demand, time, savings, passbook or like account maintained with a bank . . . other than an account evidenced by a certificate of deposit,"<sup>72</sup> the issuing bank

65. 1 Bankr. 284 (Bankr. D. Fla. 1979).

66. *Id.* at 286.

67. Banks in standby transactions often rely on collateral as varied as corporate stock or real estate; yet the most common transactions appear to be those discussed in the principal text.

68. For a comparative discussion of the deposit of money as collateral, see KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 51-53.

69. M. MEGRAH & F. RYDER, PAGET'S LAW OF BANKING 84 (London, 1972).

70. In 1980, there was a spread of approximately two percent between what leading banks paid on the prepayment by the customer-bank and what they eventually collected as interest for the time the credit was outstanding to the customer bank. Interviews with various New York & California bankers (1981-82).

71. U.C.C. § 9-104(f); see U.C.C. § 9-104 comment 7.

72. U.C.C. § 9-105(e) & comment 5.

cannot be said to have a security interest on the blocked account. Rather, what the bank has is a right of set-off. And, as stressed by Professor Murray, "it is wrong to equate set-off and banker's lien because one cannot have a lien in property he (sic) owns."<sup>73</sup> The 1978 Bankruptcy Code has preserved the bank's right of set-off, subject only to certain exceptions.<sup>74</sup>

If the security interest granted to the bank is in documents of title, goods shipped therewith and proceeds from their sale, the title to such documents and goods is conveyed to the bank not by the customer but by the beneficiary-seller or supplier.<sup>75</sup> It is true that the customer is invariably asked by the bank to sign a security agreement which grants the bank a security interest in the documents of title, goods and proceeds.<sup>76</sup> Yet, given the bank's acquisition of title to the documents by the beneficiary's endorsement, the collateral conveyed in the security agreement is nothing more than an intangible, i.e., the customer's conditional right to receive the documents once the bank decides to honor the credit and the customer reimburses the bank for such honor.<sup>77</sup> Article 9 draftsmen must have been aware of this problem because subsections 9-304(4) and (5) provide exceptions to the ordinary perfection requirements by allowing a temporary perfection from the time of the attachment of the bank's security interest without a need for filing.<sup>78</sup>

This transactional background is at odds with *Twist Cap's* assumption that the customer, clearly, is the owner of the collateral in the bank's possession. As just shown, a prepayment conveys the customer's title to the money paid to the bank, as does the deposit of cash (entitled as the customer may be to a repayment of an equivalent or larger sum of money in the event of the bank's dishonoring the credit). Similarly, all the customer has in the document of title conveyance by the beneficiary to the bank is a right to receive the documents conditioned upon the bank's honoring the credit and his timely reimbursement of the bank. It is true that section 541(a)(1) of the Bankruptcy Code defines the debtor's estate as including "all legal and equitable interests of the debtor in property as of the commencement of the case."<sup>79</sup> But whatever legal or equitable interests may be *retained* by the debtor in standby transactions, only seldom do they pertain to the collateral in the bank's possession. When they do, ownership of the collateral is totally unrelated or untraceable to the ownership of the letter of credit proceeds.<sup>80</sup>

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73. Murray, *Banks Versus Creditors of Their Customers: Set-Offs Against Customers Accounts*, 82 COMM. L.J. 449, 449 (1977).

74. See 11 U.S.C. § 553 (Supp. IV 1980) (effective Nov. 6, 1978). The exceptions are found in the automatic stay provisions, 11 U.S.C. § 362 (Supp. IV 1980), and in the trustee's right to use property under 11 U.S.C. § 363 (Supp. IV 1980). For a discussion of the exceptions to the exercise of the set-off under pre-1978 Bankruptcy Code law, see Murray, *supra* note 73, at 451-52.

75. The U.C.C. makes it clear that the collateral in a secured transaction may be owned by someone other than the debtor. See U.C.C. § 9-112. The U.C.C. also asserts that title to the collateral is, from the standpoint of article 9, immaterial. See U.C.C. § 9-202.

76. For an example of this agreement, see KOZOLCHYK, *supra* note 8, at 688-89.

77. See U.C.C. § 9-106.

78. U.C.C. § 9-304(4), -304(5); see U.C.C. § 9-304 comment 4.

79. 11 U.S.C. § 541(a)(1) (Supp. IV 1980).

80. Some standby credits, particularly those used to assure repayment of construction loans, are secured by real estate mortgages or deeds of trust in which the debtor-customer retains a legal

One commentator has aptly pointed out that *Twist Cap* is the first decision on record preventing the bank from honoring its promise of payment to the beneficiary as a result of the court's determination of the bank's rights to the collateral.<sup>81</sup> The bankruptcy court assumed that, given its findings concerning the customer's rights on the collateral, it followed that the letter of credit was equally a part of the customer's estate.<sup>82</sup> This second aspect of *Twist Cap* is as harmful as the first, for it undermines the certainty of one of the most relied-upon bank promises by subjecting it to unrelated and impermissible qualifications. As indicated earlier, the abstraction of the bank's promise requires that its enforcement be independent of, among other legal relations, the issuing bank-customer relationship.<sup>83</sup> In addition, the purported absorption of the beneficiary's right to payment of the letter of credit by the customer's estate deprives the beneficiary of property that is undisputably his. As of the time that an irrevocable letter of credit is "established," the beneficiary acquires a proprietary interest in the claim for honor of the credit against the issuing or confirming bank. True to its proprietary nature, this interest may be transferred *in toto* to any third party if the credit is labelled "transferable," or only with regard to the proceeds earned by the beneficiary's compliance if the credit is not transferable.<sup>84</sup>

*Twist Cap's* theory that the customer has a legal or equitable interest in the beneficiary's letter of credit is therefore plagued by contradictions. If there is a valid letter of credit over which the customer can assert his ownership, the beneficiary must have a valid and enforceable claim against the issuing bank. Yet how can there be such a valid and enforceable claim when the customer himself denies, first of all, that the party (and only party) that appears as its owner—and as such is entitled to enforce it—is the owner? Secondly, how can the customer assert ownership over a claim which cannot be exercised precisely as a result of his own petition for a stay or injunction? Thus, the customer's own petition and allegations render the claim over which he asserts ownership meaningless and therefore "non-property."

Another objectionable characterization in *Twist Cap* is that of the bank's honoring of the credit as a preferential treatment of the beneficiary. As pointed out by Professor Baird, the realization of the bank's security interest affects the size of the customer's estate, but the bank's payment of the letter of credit does not.<sup>85</sup> He argues, validly in this writer's opinion, that the bank's honoring of the letter of credit is nothing more than a transaction between two of the insolvent debtor's creditors—a transaction in which they may engage regardless of bankruptcy proceedings. Baird

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or equitable interest in the land or improvements. Such collateralization, however, has the least organic connection with the proceeds of the letter of credit. In other words, ownership of the letter of credit proceeds can in no manner be related or traced to the debtor-customer's ownership of real estate as the bank's payment is with its own funds.

81. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130, 132 (1982).

82. 1 Bankr. 284, 285 (Bankr. D. Fla. 1979).

83. See text & note 11 *supra*.

84. See U.C.P., *supra* note 15, at arts. 46 & 47.

85. Baird, *supra* note 81, at 133.

concludes that such a payment is not a voidable preference under the old or new bankruptcy law because the transfer does not diminish the fund available to creditors of the same class for payment of their debt.<sup>86</sup> Neither does the payment prevent the debtor's rehabilitation, as all the payment does is transfer money from one possible claimant against the debtor's estate to another.<sup>87</sup> One may add that when claiming payment on the letter of credit, the beneficiary is not acting as the insolvent customer's creditor, but as a creditor of the issuing or confirming bank. In fact, not only is the bank a different debtor, but its debt to the beneficiary, predicated solely on the terms of the credit, could also differ from that owed by the customer to the beneficiary.<sup>88</sup>

*Twist Cap's* final aspect concerns the voidability of the bank's security interest if this interest is realized during the ninety-day period prior to the filing of the bankruptcy petition, or thereafter. The reason for concern, according to Professor Baird, is that in letter of credit transactions the customer's debt comes into being when the bank and its customer enter into their security agreement and the bank issues the letter of credit, even if none of the other steps for attachment and perfection have taken place.<sup>89</sup> "Thus, if the bank has filed a financing statement before the preference period the threshold question remains whether the transfer takes place when there is attachment and perfection under state law or when the bank's liability ceases to be contingent."<sup>90</sup>

If the transfer takes place when the bank accepts or pays the beneficiary's draft, because arguably the bank's liability only ceases to be contingent at that time, then the bank's realization of the security interest following acceptance or payment could be regarded as a voidable preference. Professor Baird argues that the transfer should be deemed to have occurred when, according to state law, the attachment and perfection took place, as the policy of section 547 of the Bankruptcy Code does not require a different time.<sup>91</sup>

Policy considerations aside, however, the voidability threat should be dispelled by identifying the debt alluded to by the Bankruptcy Code as the "antecedent debt owed by the debtor before such transfer was made."<sup>92</sup> Contrary to Professor Baird's assumption, the debt incurred by the customer-debtor to the bank, as distinguished from his promise of reimbursement, does not come into being prior but subsequent to the attachment and perfection of the bank's security interest in cash or documents of title. The Bankruptcy Code defines debt as a "liability on a claim,"<sup>93</sup> and that

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86. *Id.* at 145.

87. *Id.* at 147.

88. See KOZOLCHYK, *supra* note 8, at 257-58.

89. Baird, *supra* note 81, at 149.

90. *Id.*

91. *Id.* at 150.

92. 11 U.S.C. § 547(b) (Supp. IV 1981) provides in relevant part: "Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor . . . (2) for or on account of an antecedent debt owed by the debtor before such transfer was made . . . ."

93. 11 U.S.C. § 101(11) (Supp. IV 1981).

"claim" includes not only vested but also contingent rights.<sup>94</sup> Yet, an interpretation of "debt" that would make it the equivalent of a contingent right would not only ignore its generally accepted meaning,<sup>95</sup> but also its Bankruptcy Code meaning. Such an interpretation would have to disregard the key Bankruptcy Code words "liability on" in the definition of "debt." The liability on the bank's claim to reimbursement from its customer does not come into being until the time of the bank's acceptance or payment of the beneficiary's draft. Up until this time the customer is not liable to the bank, despite the latter's attachment and perfection of its security interest on documents or goods by temporary perfection without filing, or by filing (a rare method of perfection).

The impact of *Twist Cap* should not be underestimated. It has already caused a costly disruption of domestic commercial paper markets, and prompted Standard and Poor's refusal to rate the liquidity of commercial paper backed by financial standbys.<sup>96</sup> In addition, it could have a paralyzing effect on U.S. bank standby transactions with foreign correspondents. Assume, for example, that a U.S. bank is asked by a local customer to procure the confirmation of its standby credit from a foreign correspondent bank. The local customer, however, becomes insolvent during the transaction. Since the foreign correspondent will simply debit the account of its U.S. correspondent upon its acceptance or payment, regardless of a *Twist Cap* stay or injunction, the U.S. bank will be faced with an unreimbursed payment, and thus, with a clearly undesirable transaction. Further, any attempt to apply *Twist Cap* extra-territorially is bound to be dismissed abroad, not only because of the foreign court's exercise of its legitimate jurisdictional powers, but also because of *Twist Cap's* own presuppositions. It will be recalled that according to *Twist Cap*, the property that would have to be considered by the foreign court when honoring a U.S. injunction could not be that of the original U.S. customer, who is a stranger to the foreign bank, but rather the U.S. bank's balances with its correspondent bank. And such property, in all likelihood, would no longer belong to an insolvent *Twist Cap*-like debtor, but rather to a highly solvent one.

For these reasons it is important to heed Senator DeConcini's warning, instrumental as he was in the adoption of the Bankruptcy Code: "Contrary to the language of *Twist Cap* . . . payments of the commercial paper by the letter of credit bank . . . are not preferential or enjoined since payments are not being made with the property of the estate. . . ."<sup>97</sup>

#### D. *Post Script*

Shortly after the preceding section was completed, the United States District Court for the District of Columbia decided *Westinghouse Credit*

94. 11 U.S.C. § 101(4) (Supp. IV 1981).

95. See BLACK'S LAW DICTIONARY 491 (4th ed. 1951): "A sum payable upon a contingency, however, is not a debt . . . until the contingency has happened."

96. Baird, *supra* note 81, at 132 n.10; see also *Letter of Credit Collateral—A Spur to the Wary*, 98 Banking L.J. 579 (1981).

97. 126 CONG. REC. S15174 (1980) (statement of Sen. DeConcini).

*Corp. v. Page*.<sup>98</sup> In this case, the beneficiary of a standby credit obtained a reversal of the bankruptcy court's injunction against the bank's "honoring, paying or funding and receiving money pursuant to its letter of credit."<sup>99</sup> The insolvent debtor pledged collateral which consisted of a certificate of deposit and a second deed of trust. The district court set aside the bankruptcy court's preliminary injunction and, contrary to *Twist Cap*, held:

In issuing the letter of credit the Bank entered into an independent contractual obligation to pay WCC out of its own assets. Although cashing the letter of credit will immediately give rise to a claim by the Bank against the debtors pursuant to the latter's indemnification obligations, that claim will not divest the debtors of any property since any attempt to enforce the claim would be subject to an automatic stay pursuant to U.S.C. 362(4).<sup>100</sup>

The district court's holding unequivocally favors the beneficiary by relying on what the court termed the bank's ownership of the letter of credit and of its proceeds.<sup>101</sup> Although the court's disregard of the beneficiary's ownership is questionable in an established letter of credit,<sup>102</sup> it is still preferable to *Twist Cap*'s conferral of ownership of the letter of credit to the insolvent customer.

The district court, however, was less forthcoming on the bank's right to realize on the collateral once it paid the beneficiary. On the one hand, the court admitted that the bank's lien on the collateral was created prior to the bankruptcy and remained valid as a perfected security interest for future cash advances against the trustee in bankruptcy.<sup>103</sup> This was predicated upon the same conclusion suggested by this writer in the preceding section, that the perfection of the bank's security interest takes place at the time of the issuance of the letter of credit and not when the letter of credit is paid.<sup>104</sup> On the other hand, however, the court held that the bank's payment of the letter of credit does not bring about a transfer of the debtor's property to the bank because the enforcement of the bank's claim to the collateral is *barred* by section 362 of the Bankruptcy Code.<sup>105</sup> The contrast between the beneficiary's and the bank's rights is also evident in the following statement:

As between compromising either the Bank's claim or WCC's claim to the \$500,000 in dispute it is necessary in the circumstances of this case to permit the Bank to carry through on its contractual obligations and to require the Bank, not WCC, to suffer the possible ad-

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98. No. 81-3172 (D.D.C. Mar. 30, 1982). I am grateful to the law offices of Rosen, Wachtell & Gilbert of Los Angeles for alerting me to this decision.

99. *Id.* at 1.

100. *Id.* at 4.

101. In addition to the language quoted in the text, the court stated that: "the letter of credit and its proceeds represent property of the bank, not the debtors." *Id.* at 6. Query: does not the time of establishing the credit make a difference? See U.C.C. § 5-106.

102. Westinghouse Credit Corp., slip op. at 6.

103. "Since a trustee in a Chapter 11 proceeding is a hypothetical lien creditor, see 11 U.S.C. § 544(a), a prior lien created as part of a future advance arrangement is valid against the trustee in a Chapter 11 proceeding." *Id.* at 5.

104. *Id.*

105. *Id.* at 6.

verse consequences of a penurious debtor.<sup>106</sup>

Such a restrictive view of the bank's rights to realize on collateral after its debtor's insolvency attributes a disturbing finality to the Bankruptcy Code's automatic stay provisions. Contrary to what may be the case with the assignment of a certificate of deposit as prepayment for the issuance, or with the conveyance of legal and beneficial interests to the bank in personal or real property valued at more than the amount of the issuance and payment, the district court assumes the inevitability of the debtor's equity of redemption. Otherwise, why assume that the collateral will always qualify as property of the debtor-customer's estate? It seems clear that if damaging uncertainty is to be avoided, future decisions will have to take into account the kaleidoscopic nature of the bank's collateral, and the frequent absence of a customer's equity thereon.

E. *Comptroller's Interpretive Ruling 7.7016 of 1977 and Ultra Vires Standbys*

In 1966, this author suggested that if what prompted the *ultra vires* characterization of standby and guaranty credits was the risk of unreimbursed payments, the wisest course with regard to these new types of credit was not to impede their issuance but to carefully monitor and regulate their collateralization.<sup>107</sup> As indicated earlier,<sup>108</sup> the Comptroller's Interpretive Ruling 7.1160 adopted a similar point of view when subjecting standby credits to 12 U.S.C. § 84 lending limits. The related question of what standby issuance should qualify as a letter of credit, as contrasted with its disqualification as an *ultra vires* guaranty, was answered in part by the Comptroller's Interpretive Ruling 7.7016 of May 1977.<sup>109</sup> The remainder of the answer was provided, as will be apparent in the following section, by the courts. After listing the formal elements normally associated with a commercial letter of credit, the Ruling states:

(d) the bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary; (e) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit.<sup>110</sup>

These guidelines are sounder than those in Interpretive Ruling 7.1160 because they do not seek to identify acceptable standbys on the basis of their "non-takedown" expectation. They are also superior to the primary and secondary liability dichotomy introduced to commercial letter of credit law by Judge Learned Hand in a poorly reasoned and yet highly influential 1925 dissent.<sup>111</sup> Properly interpreted, therefore, Interpretive

106. *Id.* at 7.

107. KOZOLCHYK, *supra* note 8, at 634-35.

108. See text & notes 57-58 *supra*.

109. Ruling 7.7016, note 63 *supra*.

110. *Id.*

111. *Pan American Bank & Trust Co. v. National Bank*, 6 F.2d 762, 769 (2d Cir. 1925) (Hand, J., dissenting). For a critical evaluation of Judge Hand's dissent, see KOZOLCHYK, *supra* note 8, at

Ruling 7.7016 should be quite helpful to administrators, bankers, commercial lawyers and courts alike. Unfortunately, however, there is a tendency among some practitioners to read these guidelines too literally and as if the guidelines addressed not the soundness of banking practices but the validity or enforceability of each letter of credit.<sup>112</sup> Such interpreters assume that unless a standby meets all the listed criteria, and meets them literally, it is not an enforceable letter of credit. The absurdity of such an interpretation becomes apparent when one considers that a literal reading of 7.7016(e) would disqualify a standby issued on behalf of, say, American Bell International, because as a corporation, its liability would be limited and thus its promise of reimbursement under 7.7016(e) would be a "qualified" one. Similarly, a promise of reimbursement by another highly solvent debtor willing to provide sufficient collateral may be disqualified as a result of limitations on the debtor's budgetary authority which require that commitments be made only for the duration of a fiscal year.

Such interpretations not only clash with the regulatory purpose of encouraging properly collateralized issuances, but also conflict with the U.C.P. and U.C.C. cardinal principles that separate the validity of a letter of credit from underlying relationships or equities. They also ignore the Ruling's own referral of the permissibility of each issuance to the U.C.C. and the U.C.P. rules.<sup>113</sup>

### *Summary and Conclusions*

The power to issue commercial letters of credit is, by now, unquestioned and only the effects of the issuance upon the bank's solvency and liquidity, particularly after it ceases to be a contingent liability, are regulated. The issuance of improperly secured standbys embodies a greater degree of risk of unreimbursed payment for the issuing or confirming bank than does the commercial letter of credit. Most standbys are payable at sight, and a good number are payable upon the presentation of "simple demands" documentation. Moreover, unlike the commercial letter of credit, the documents submitted with most standbys lack commercial or

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630-35 & discussion at note 9, *supra*. The primary-secondary liability dichotomy is apparent in many of the decisions discussed in text & notes 116-261 *infra*. See, e.g., *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank*, 493 F.2d 1285 (9th Cir. 1974); *Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109, 116 (Tex. 1979).

112. In *Karpasia Shipping Co. v. Chase Manhattan Bank World Trade Center*, No. 79-1772 (S.D.N.Y. July 3, 1980) (available on LEXIS), the court noted that the Comptroller stated his reason for revising his ruling as follows:

Clarification was deemed desirable because some national banks, issuers of letters of credit, believing the five standards listed in the previous ruling to be mandatory, have refused to honor drafts drawn under their letters of credit on the ground that the instrument failed to meet the Comptroller's standards and was therefore not a "true letter of credit transaction." As revised, the ruling makes clear that, while national banks for safe and sound banking purposes should issue their letters of credit in conformity with the ruling's standards, the determination of the letter of credit's legality and whether it should be honored is governed solely by statutory law, such as the Uniform Commercial Code, or by Convention, such as the Uniform Customs and Practices for Documentary Credits.

*Id.*, quoting 42 F. Reg. 24206 (1977).

113. *Id.*



"self-liquidating" value. Higher risks have resulted in a policy of treating those standbys that are not fully prepaid or secured by segregation of funds as loans to the customer. Standbys must also be reported in footnotes to the banks' balance sheets. This regulation came about after the failure of some large national banks which engaged in the unrestricted issuance of standbys as guarantees of repayment of loans obtained by the banks' stockholders and dummy corporations. Several attempts to impose a stricter regulation of standbys have failed because of the findings in empirical studies undertaken upon Senatorial request by the research staff of the Board of Governors of the Federal Reserve Board. These studies concluded that the present means of regulation were adequate in policing the safety and soundness of the standby issuances, and that the cost of proposed measures such as application of reserve requirements or inclusion within the 12 U.S.C. § 82 limits would be too high and anti-competitive. While reviewing the Federal Reserve studies, this author noted the unexplained sharp contrasts in the collateralization of issuances to foreign and to United States beneficiaries. To the extent that such disparity reflects the reliance on correspondent banks' balances as de facto collateral, an unverified but nonetheless plausible hypothesis, it also embodies a risky practice. This would be particularly true in transactions with Persian Gulf correspondents.

The soundness of collateralization has also been imperiled by the bankruptcy court in *Twist Cap*.<sup>114</sup> This decision's assumption that the bank's collateral is property of the insolvent customer's estate makes it possible for the trustee to obtain a stay against the realization of the bank's perfected security interest. More significantly, the *Twist Cap* court's approach can lead to the granting of an injunction against payment of the credit and to a finding of voidability, as a preference, of the realization of the bank's security interest within the ninety-day period prior to bankruptcy or as a post-petition transfer. These rules have already created serious national disruption and could also have detrimental international implications. They reflect a basic misunderstanding of standby and commercial letter of credit transactions, law and practice.

The Comptroller's Interpretive Ruling 7.7016 has provided a sound, albeit partial, basis with which to determine when standbys qualify as letters of credit and not as *ultra vires* guarantees. The Ruling should not, however, be interpreted too literally or as if it provides the final answer to the question whether a given standby is enforceable as a letter of credit. This question must be answered, by the Ruling's own directive, by the U.C.C. and by the U.C.P. The Ruling's deference to the U.C.C. and U.C.P., and with them to sound commercial and banking practice,<sup>115</sup> embodies a commendable regulatory policy.

The object of regulation in letter of credit law, as well as in other commercial law institutions, is not to protect those who enter into transac-

114. *Twist Cap, Inc. v. Southeast Bank*, 1 Bankr. 284 (Bankr. D. Fla. 1979).

115. See U.C.C. § 5-102(3) and U.C.P. General Provision (a), note 15 *supra*, which leave considerable leeway to the parties' stipulations.

tions with open and knowing eyes, but those whose participation is handicapped by their ignorance or weakness or who are helpless but nonetheless affected bystanders. Clearly, the bank's shareholders and depositors whose ownership and creditor's rights could be imperiled by issuances of standbys are affected bystanders. An equally affected bystander, in a larger sense, is the public, the value of whose money or quasi-money could suffer by widespread standby illiquidity. Adequate protection, however, requires precise identification of the risks and weighing of the costs inherent in stamping out or restricting commercial practices. The risks involved in standby issuance are not inherent in the use of the guarantee label or in the assumption of a "secondary" as opposed to a "primary" liability. Rather, risks arise in the bank's involvement with underlying transactions instead of with the payment of monetary promises susceptible to documentary verification by banking employees. This risk goes hand-in-hand with the issuance of highly liquid monetary promises that are improperly or deficiently collateralized.

### III. THE DECISIONAL CONTEXT

The increasing use of standby credits in the United States has brought about a marked proliferation of litigation. While up to the mid-sixties, the number of reported letter of credit decisions rarely exceeded a handful per year, from 1977 to 1981 the yearly average nearly trebled.<sup>116</sup> Many of these decisions involve allegations of the beneficiary's fraud in the presentation of the required documents.<sup>117</sup>

That fraud should have become such a central issue should not be surprising given the extraordinary powers conferred upon the beneficiary particularly by the simple demand standby letter of credit. Unlike what happens in the ordinary commercial transaction, one party does have the power to dictate the other's irrevocable liability. And, the stronger the beneficiary's power to bind the issuing or confirming bank to effect payment and to debit its customer's account, the greater the chances of an abuse of power or of a perception of such an abuse by the bank's customer.

Since the problems of fraud in the standby transaction have received considerable and competent attention,<sup>118</sup> the present discussion will concentrate on those other key aspects of judicial and customary decisionmaking that have received less notice. In a decreasing order of generality,

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116. As of the time of this writing, 67 cases have been published (62 reported and 5 available in Lexis as slip opinions) concerning standby letters of credit since 1976. Of these, 35 are state court decisions and 32 are federal district and circuit court opinions.

117. Eighteen, or almost one-fourth of the reported decisions, were concerned with alleged fraud by the beneficiary. In eleven of these cases, payment was to be made upon the beneficiary's simple demand or certification of default.

118. See, e.g., Geva, *Contractual Defenses as Claims to the Instrument: The Right to Block Payment on a Banker's Instrument*, 58 OR. L. REV. 283 (1979); Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596 (1978); Symons, *Letters of Credit Fraud: Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338 (1980); Note, *A Reconsideration of American Bell International, Inc. v. Islamic Republic of Iran*, 19 COLUM. J. OF TRANSNAT'L L. 301 (1981); Note, *Judicial Development of Letter of Credit Law: A Reappraisal*, 66 CORNELL L. REV. 144 (1980); Note, *"Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992 (1980).

these are: 1) What are the sources of standby letter of credit law? 2) What are its elements including binding language, designation of a beneficiary and expiration date? 3) What standards of verification of documents apply to standbys? and 4) How abstract is the standby promise?

### A. Sources of Law

American court decisions have characteristically shied away from making general pronouncements on the scope and applicability of particular sources of standby letter of credit law. Different sources of law have been applied in a pragmatic or problem-oriented fashion. If, for example, the question was whether a bank had abused its power of issuing letters of credit, federal and state regulatory decisions were applied to the exclusion of other sources.<sup>119</sup> If, however, the problem was whether a given document complied with the express terms of a standby credit, then often as not the U.C.P. was applied without questioning whether it governed standby credits.<sup>120</sup> And, when the issue was not addressed by the U.C.P., as with the court's power to enjoin payment of a standby upon allegation of the beneficiary's fraud, courts unhesitatingly applied U.C.C. article 5 provisions.<sup>121</sup> Yet one source of international guarantee law, the I.C.C. Rules,<sup>122</sup> has remained virtually ignored by American court decisions. The reason for such ignorance can be traced to the fact that American banks, worried about the *ultra vires* implications of credits labelled "guarantees," do not incorporate or refer to the I.C.C. Rules in their standby credits as is done by some European or Middle Eastern banks.<sup>123</sup> Nevertheless, if a standby credit containing such an incorporation or reference were to become the subject of litigation in the United States, it would be advisable to remember that some I.C.C. Rules presuppose the issuer's involvement with the determination or with the completion of performance of the underlying contract.<sup>124</sup> Since this involvement is contrary to what courts in the United States assume is the bank's role in a documentary and in a standby credit,<sup>125</sup> application of the I.C.C. Rules could lead to disconcerting antinomies.<sup>126</sup>

119. See, e.g., *Bank of N.C. v. Rock Island Bank*, 570 F.2d 202 (7th Cir. 1978), *rev'd following remand*, 630 F.2d 1243 (7th Cir. 1980); *First Empire Bank v. Federal Deposit Ins. Corp.*, 572 F.2d 1361 (9th Cir. 1978); *New Jersey Bank v. Palladino*, 77 N.J. 33, 389 A.2d 454 (1978); *United Bank of Denver Nat'l Assoc. v. Quadrangle, Ltd.*, 42 Colo. App. 486, 596 P.2d 408 (1979).

120. See, e.g., *First Nat'l Bank v. Wynne*, 149 Ga. App. 811, 256 S.E.2d 383 (1979).

121. See, e.g., *KMW v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979); *Roman Ceramics Corp. v. Peoples Nat'l Bank*, 517 F. Supp. 526 (D. Pa. 1981); *American Bell Int'l v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979); *Colorado Nat'l Bank v. Board of County Comm'rs*, — Colo. —, 634 P.2d 32 (1981); *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 336 A.2d 316 (1975).

122. I.C.C. RULES, note 10 *supra*.

123. See generally Poullet, *Les Garanties Contractuelles dans le Commerce International*, 5 INT'L TRADE L. & PRAC. 387, 393-98 (1979). For a description of various guarantee clauses, see Gavaldà & Stofflet, *La Lettre de Garantie Internationale*, 1981 REVUE TRIMESTRIELLE DE DROIT COMMERCIAL ET DE DROIT ECONOMIQUE 1, 6, 16-17; Eberth, *Der standby Letter of Credit im Recht der Vereinigten Staaten von Amerika*, 1981 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT 80.

124. See note 10 *supra*.

125. See text & notes 238-40 *infra* for a discussion on abstraction.

126. The drafters of the I.C.C. Rules seem aware of such a problem, for they did not find it

Conflict among the various sources of standby letter of credit law is bound to arise in a case-by-case approach to the determination of sources and hierarchy of rules. As long as there is no prior determination of the validity and rank of sources, problems such as outlined hereafter will remain unresolved: If a standby credit does not express its revocability, given conflicting presumptions in the U.C.C. and U.C.P., which presumption shall be applied? Would U.C.C. article 5 presumption of irrevocability or the U.C.P. article 1(c) presumption of revocability be applicable?<sup>127</sup> Will the Comptroller of the Currency's Interpretive Ruling 7.7016 of May, 1977, be adjudged to require proof of a customer's unqualified obligation to reimburse the bank before allowing a standby's enforceability, contrary to what the U.C.C. and the U.C.P. require? Will the period allowed an issuing bank for its examination of standby documents be governed by the three banking days provision of U.C.C. section 5-112 or the "reasonable time" provision of article 8(d) of the U.C.P.? Given the present uncertainty, the proposed revision of the U.C.P. stating that standby credits are to be governed by the U.C.P. is, on the whole, a welcome development.<sup>128</sup> It is true that provisions such as article 46 on the transfer of the letter of credit are unsuitable for financial standby practice.<sup>129</sup> But as long as the U.C.P. and U.C.C. are regarded as setting forth only the basic formal requirements for the validity and enforceability of standby credits, courts will enjoy a sound basis for their interstitial contributions. Those standbys which do not meet the U.C.P. or U.C.C. requirements simply will have to earn their place in commercial transactions law on their own and not as disguised documentary letters of credit. It can also be predicted that in the absence of a legislative determination of the hierarchy of standby letter of credit law, a determination which would require uniform action by fifty state legislatures to be truly effective, it will be the responsibility of decisional law to establish such a hierarchy.<sup>130</sup>

### B. *Elements of Validity*

A valid commercial letter of credit consists of a writing in a format acceptable to banks and other regular participants in the transaction, such as a letter, telegraph or telex communication. The writing must also contain language deemed binding by the various participants and courts.<sup>131</sup>

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practicable to deal with the abstraction "because of the differing approaches to the matter under various national legislations." I.C.C. RULES, note 10 *supra*.

127. See *Beathard v. Chicago Football Club, Inc.*, 419 F. Supp. 1133 (N.D. Ill. 1976); *cf.* *Data Gen. Corp. v. Citizens Nat'l Bank*, 502 F. Supp. 776 (D. Conn. 1980). See also *Karpasia Shipping Co. v. Chase Manhattan Bank World Trade Center*, No. 79-1772 (S.D.N.Y., July 3, 1980) (available on LEXIS).

128. Revision of Uniform Customs and Practice for Documentary Credits, I.C.C. Doc. No. 470/394B (Apr. 19, 1982). Article 1 states: "These provisions, definitions and articles apply to all credits including, where applicable, Stand-by letters of Credit . . ."

129. See text & notes 182-85 *infra*.

130. For a good illustration of a judicial determination of hierarchy of standby letter of credit law sources (Comptroller's May 1977, Interpretive Ruling 7.7016, note 63 *supra* versus the U.C.C. and the U.C.P.), see *Karpasia Shipping Co. v. Chase Manhattan Bank World Trade Center*, No. 79-1772 (S.D.N.Y. July 3, 1980) (available on LEXIS). For a comparative law analysis, see Eberth, *supra* note 123, at 36-39.

131. KOZOLCHYK, *INTERNATIONAL ENCYCLOPEDIA*, *supra* note 5, at 92-99.

In addition, the writing should contain the issuing bank's name, its signature, the credit number, a stated amount, the designation of a beneficiary, and a specification of terms and dates for the beneficiary's compliance and for the expiration of the credit.<sup>132</sup> Inclusion of other statements such as the denomination or type of credit, while highly advisable, are not essential as is the preceding information.<sup>133</sup> Of the above listed requirements, a binding language and the designation of the beneficiary have attained special significance in the emerging law of standby letters of credit.

### 1. *Binding Language*

On June 5, 1969, the President of Rock Island Bank, an Illinois bank, wrote the following letter on the bank's letterhead to Lorraine Realty Corporation:

We hereby issue to Lorraine Realty . . . our irrevocable and unconditional commitment to purchase your promissory note of this date in the amount of \$400,000.00, said Promissory Note to bear a maturity date of June 5, 1971.

We will purchase said Promissory Note from its holder in due course at maturity, provided the holder of such Promissory Note shall give us at least 60 days written notice of its intent to sell to us prior to delivery date, said delivery date not to be prior to maturity date of June 5, 1971. We hereby agree with the drawers, endorsers and bona fide holders that this credit will be duly honored on presentation in an amount not to exceed unpaid balance of principal and interest due upon presentation.<sup>134</sup>

Lorraine Realty drew the promissory note for \$400,000 in favor of Sumner Financial Corporation. Sumner negotiated the note to the Bank of North Carolina, which tendered the note for payment on June 5, 1971. The Bank of Rock Island refused to pay or purchase the note, alleging it to be an *ultra vires* guarantee under Illinois law. The Bank of North Carolina, on the other hand, contended that the letter was an enforceable letter of credit. The United States Court of Appeals for the Seventh Circuit agreed.<sup>135</sup> The court rejected the allegation that agreements to repurchase securities at their face value by banks were *ultra vires* by pointing to two Illinois statutory provisions—one which repealed the prohibition against banks issuing promises to guarantee the debts of another, and one which authorized the issuance of letters of credit.<sup>136</sup> The court found that the language contained in a letter of credit was binding based on the Illinois Commercial Code. Section 5-103(1)(a) of the U.C.C. defines a letter of credit in terms of a literal promise:

"letter of credit" means an engagement by a bank or other person made at the request of the customer and of a kind within the scope of

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132. *Id.* at 95-97.

133. *Id.* at 98.

134. *Bank of N.C. v. Rock Island Bank*, 570 F.2d 202, 204 (7th Cir. 1978), *rev'd following remand*, 630 F.2d 1243 (7th Cir. 1980).

135. 570 F.2d 202, 205.

136. *Id.*

this Article (Section 5-102) *that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.*<sup>137</sup>

In addition, the court interpreted the cross reference to U.C.C. section 5-102 as meaning that an enforceable letter of credit requires either a documentary draft or a documentary demand for payment, or that it conspicuously states that it is a letter of credit or is conspicuously so entitled. Since the letter in question did not conspicuously state that it was a letter of credit, nor was it so entitled, the court's finding of enforceability depended upon the determination that the letter in question required presentation of a documentary draft or demand for payment as a precondition for purchasing or paying the note. The court found that the letter did require presentation of a documentary draft or demand for payment given the expansive meaning provided by section 5-103(1)(b): "Document means any paper indicating document of title, security, invoice, certificate notice of default and the like."<sup>138</sup> The court also buttressed the finding of enforceability by stating that unlike a true guaranty, the guaranty letter of credit obliges its issuer to pay on the presentation of specified documents showing default, rather than upon actual proof of default.<sup>139</sup> Despite the location of this statement in a footnote, this was a crucial finding because U.C.C. section 5-102(2), upon which the court expressly relied, excludes guarantees from article 5 application.

A standby promise was thus found enforceable if it complied with the same requirements of literality found in U.C.C. sections 5-102 and 5-103 for commercial letters of credit. This finding of parallelism with commercial letter of credit law involves more than what may appear at first sight. If in order to be distinguished from a "true guaranty," a standby promise must perforce be abstract in nature, then more is required from it than from a commercial letter of credit promise. While it is true that a commercial letter of credit promise should concern itself only with documentary and not with underlying contract compliance, there is no statutory, judicial or customary basis for declaring unenforceable a promise where a bank, contrary to Frank Sauter's good advice, agrees to ascertain that the merchandise shipped was exactly as requested in the underlying agreement.<sup>140</sup>

It is also important to note the commercial letter of credit requirements that were not present in the Rock Island Bank letter of June 5, 1969. There was no statement indicating that it was a letter of credit, nor was there any reference to a date of presentation of documents nor of expiration of the promise. In addition, the court failed to question the Bank of North Carolina's right to effect tender as if it were the original beneficiary. Further, if the Bank of North Carolina were acting as if it were an original beneficiary, would not such a status violate the U.C.P. rule that limits transferability of a beneficiary's rights only to transferable credits, and then only to one transfer? The court seemed to sense the presence of gaps

137. ILL. REV. STAT. ch. 26, § 5-103(1)(a) (1963) (emphasis added).

138. 570 F.2d at 207, 208.

139. *Id.* at 206 n.7.

140. See note 14 *supra*.

in its analysis and accordingly resorted to three venerable principles of equitable decisionmaking:

- 1) An interpretation that will sustain an instrument will be preferred to one that will defeat it;
- 2) Where a contract is susceptible to two interpretations, one which makes it fair and customary, the other which makes it inequitable, the former will be preferred;
- 3) An ambiguous contract will be construed most strongly against the party who prepared it.<sup>141</sup>

The same principles were applied by the United States District Court for the Southern District of New York in its July, 1980 unpublished decision in *Karpassia Shipping Co. v. Chase Manhattan Bank World Trade Center*.<sup>142</sup> This case involved a non-financial standby issued in favor of plaintiff, a Greek shipping company owner of a chartered vessel, to assure the payment of per-day demurrage charges as agreed between the bank's customer and plaintiff. Upon its customer's request, the defendant bank issued a telex to Bank of America in Piraeus, Greece, which in relevant part read:

We guarantee demurrage payment of \$2,000 per day unlimited. Beneficiary Account Number 522. Demurrage payable upon statement of fact on a Master Time Sheet signed by agent and presented to us.<sup>143</sup>

The court found that the reference to "Beneficiary Account Number 522" alluded to plaintiff's account with the Bank of America in Piraeus, and also that the telex was sent by means of a coded test key so that the Bank of America could ascertain that Chase Manhattan was the sender. Upon presentation of the documentation of the demurrage charges, Chase Manhattan refused to pay, alleging first, that it was merely conveying the guarantee agreement of its customer without intending to assume the guarantee obligation. With the *contra proferentem* principle looming large, the court disposed of Chase's first contention by stating, proverbially, that "banks do not ordinarily act as corresponding secretaries for their customers."<sup>144</sup>

The remaining motions by Chase's counsel raised highly significant issues. As done by counsel for the Rock Island Bank in the preceding case, Chase's counsel alleged that the telex was not an enforceable letter of credit, but rather an illegal and thus unenforceable guarantee. In dealing with this issue, the court relied on the *Rock Island Bank* distinction between a valid obligation predicated upon the issuing bank's "dealing" in documents and an invalid guarantee where it got involved in the performance of the underlying contract.<sup>145</sup> The court similarly relied on the definition of a letter of credit in U.C.C. section 5-103(1), which in New York

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141. 570 F.2d at 207.

142. No. 79-1772, slip op. at 9 (S.D.N.Y. July 3, 1980) (available on LEXIS).

143. *Id.* at 3.

144. *Id.* at 5.

145. *Id.*

applied subsidiarily to general provision (b) of the U.C.P.<sup>146</sup> The court then turned to Chase's argument that the telex in question failed to meet the criteria listed by the Comptroller of the Currency in Interpretive Ruling 7.7016 of May, 1977. Chase argued that, based on this ruling, the court should be leery of labeling the document a letter of credit. Describing such an argument as an advocacy "in terrorem,"<sup>147</sup> the court pointed out that the ruling was drawn precisely to clarify the point that the listed criteria did not address the validity or enforceability of letters of credit. And, since the ruling only addressed the question of what was a safe and sound banking practice in connection with the issuance of instruments whose validity and enforceability was determined by the U.C.C. and the U.C.P., it was for the issuing bank and not for the court to be leery about "so grave a departure from safe and sound banking practice."<sup>148</sup>

Thus, even though the telex in question lacked an express designation of a beneficiary, so long as the beneficiary could be identified by its account number with the Bank of America, the credit was enforceable. Similarly, the court did not find the absence of a statement of total amount of liability or of a presentation or expiration date, or the possibly vague expression of the bank's promise, fatal flaws. Finally, the court distinguished Chase's promise from that by the issuing bank in *Wichita Eagle & Beacon Publishing Co. v. Pacific National Bank*,<sup>149</sup> which held that a bank's ascertaining and assuring performance in an underlying contract rendered its promise *ultra vires*. The *Karpassia* court found that Chase was required by its telex to deal simply in documents without reference to proper performance of the separate underlying contract.<sup>150</sup>

In comparing the *Chase Manhattan Bank* and *Rock Island Bank* decisions, it appears that *Rock Island Bank* found the basis of standby letter of credit binding language in the U.C.C. article 5 principle of literality, and in the court's own requirement of abstraction or separation from underlying transaction verification of default. In doing this it went beyond the requirements for commercial letters of credit. The *Chase Manhattan Bank* decision agreed with these tenets and clarified the point that what consti-

146. The text of U.C.C. § 5-102(1) was modified in chapter 327 of the New York Laws of 1963, effective Sept. 27, 1964, and reads in part:

(1) Except as otherwise provided in subsection (4) of this section, this Article applies . . . .

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

*Id.*; see *Marine Midland Grace Trust Co. v. Banco del Pais*, 261 F. Supp. 884, 886 (S.D.N.Y. 1966).

147. No. 79-1772, slip op. at 7 (S.D.N.Y. July 3, 1980) (available on LEXIS).

148. *Id.* at 8.

149. 493 F.2d 1285, 1286 (9th Cir. 1974). The guaranty features of the operative instrument, as described by the Ninth Circuit Court of Appeals, were: "the instrument is an ordinary guaranty contract, obliging the defendant bank to pay *whatever the lessee Circular Ramp Garages, Inc. owed on the underlying lease*, up to the face amount of the guaranty." *Id.* at 1286 (emphasis added).

150. No. 79-1772, slip op. at 9 (S.D.N.Y. July 3, 1980) (available on LEXIS).



tuted binding language for standbys was not governed by the criteria listed in the Comptroller's May 1977 Interpretive Ruling 7.7016. In addition, a number of formal requirements of commercial letters of credit, such as expression of denomination, amount, designation of beneficiary, presentation and expiration dates, were dispensed with by one court or the other. Thus, these two decisions can be regarded as having set forth the minimum requirements of binding language in the standby promise. This is not to say that they dispensed with the excused requirements in all issuances, for depending on the circumstances of a given issuance any of the requisites can indeed be essential. When the terms of a standby can be inferred without the above requirements, however, there is now authority for their excuse.

The issue in the *Rock Island Bank* decision concerning the status of the Bank of North Carolina as a beneficiary-transferee or holder in due course of Lorraine Corporation's note remained unresolved. This is a question that, as will be seen shortly, can be raised with many a financial standby method of presentation of documents and payment.<sup>151</sup> Nevertheless, both decisions performed a service by linking the enforceability of standby credits to traditional principles of equitable interpretation. And, as pointed out by Dean Stoufflet, the linkage between commercial practice and general principles of the French law of obligations (a French counterpart to the Anglo-American equitable principles of interpretation) has proven essential to a sound development of commercial letter of credit law.<sup>152</sup>

Given the crucial role of literality and abstraction in standby promises, it is important to determine what particular language has been deemed unacceptable by the courts. A letter of credit, in a landmark decision by the Ninth Circuit,<sup>153</sup> required payment against documents indicating that the customer-lessees had failed to complete construction of a parking garage. The court labeled the bank's promise an *ultra vires* guarantee because it required the issuer to do more than deal in documents.<sup>154</sup> This raises the following question: Is the test generally applied by the courts a mechanical one, so that if the word "guarantee" is used repeatedly, and regardless of whether the bank only deals in documents, the instrument would not qualify as a letter of credit? A decision by the Court of Appeals of Oklahoma seemed to apply such a mechanical test when it held that an instrument promising payment against unpaid invoices, and using repeatedly the term "guarantee," was not a letter of credit.<sup>155</sup> Yet, such a construction did not relieve the issuing bank of liability, but did just the opposite by applying guarantee rules which were not as strict on expiration dates as letter of credit rules. By contrast, in *New Jersey Bank v.*

151. See text & notes 183-85 *infra*.

152. Stoufflet, *Payment and Transfer in Documentary Letters of Credit: Interaction Between the French General Law of Obligations and the Uniform Customs and Practice*, 24 ARIZ. L. REV. 267, 276 (1982).

153. *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank*, 493 F.2d 1285, 1286 (9th Cir. 1974).

154. *Id.*

155. *Dubuque Packing Co. v. Fitzgibbon*, 599 P.2d 440 (Okla. App. 1979).

*Palladino*,<sup>156</sup> the Supreme Court of New Jersey deemed what a lower court found in effect to be a letter of guaranty nonetheless an enforceable standby letter of credit.<sup>157</sup> And, the Supreme Court of Texas in a 1978 decision held that language indicating that the purpose of the instrument was to guarantee payment of a balance due on a promissory note, and referring in detail to the underlying transaction, was nonetheless an enforceable standby.<sup>158</sup>

Moreover, the insertion of the stipulation that "this letter of credit relates to working capital funds for the captioned project" did not prevent payment of a letter of credit to a mortgagee beneficiary in a 1976 decision by the United States District Court for the Western District of Pennsylvania.<sup>159</sup> Payment was upheld by the court even though there was a question as to underlying contract wording and performance.<sup>160</sup> Similarly, references in the purported letter of credit to an underlying assignment of funds and to a certification written in accordance with a detailed purchase order, payment of which by the customer could be offset against the amount of the standby letter of credit, was held not to harm its enforceability in a 1980 decision by the United States District Court for the District of Connecticut.<sup>161</sup>

A summary review of other decisions provides some additional features of the binding language. The issuer's promise must not only be literal and abstract, but it must also be definite or unconditional in nature. For example, the following promise was deemed unenforceable because of indefiniteness:

Please be advised that we have committed to Mr. Trier for real estate mortgage loan in the amount of . . . subject to our holding a first and paramount lien on this property. The home is to be constructed as per plans and specifications submitted.<sup>162</sup>

In the words of the Iowa Supreme Court, what was missing was "the essential element of a direct promise by the bank to pay the addressee of the

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156. 77 N.J. 33, 389 A.2d 454 (1978).

157. *Id.* at 38, 389 A.2d at 457: "The Appellate Division's reversal was grounded on the finding that the letter was a guaranty and was therefore illegal under N.J.S.A. 17:9A-213.1, which prohibits banks from guaranteeing obligations of others."

158. *Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109, 116 (Tex. 1979): "While it is true that the instrument refers to the underlying transaction, it has been held that such general references may be disregarded as surplusage unless they impose some condition to the issuer's liability." See also *Lustrelon, Inc., v. Prutscher*, 178 N.J. Super. 128, 428 A.2d 518 (1981); *East Bank v. Dovenmuehle, Inc.*, 196 Colo. 422, 589 P.2d 1361 (1978).

159. *West Virginia Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1111 (W.D. Pa. 1976).

160. *Id.* at 1115.

161. *Data Gen. Corp. v. Citizens Nat'l Bank*, 502 F. Supp. 776 (D. Conn. 1980). See also *Fidelity Bank v. Lutheran Mut. Life Ins. Co.*, 465 F.2d 211 (10 Cir. 1972), where the standby credit stated that it was "to serve as a standby deposit of \$10,500.00 to guarantee their consummation of a loan of \$525,000.00 on real property described as follows . . ." 465 F.2d at 212. While a misdescription was found in the clause reciting the purpose of the letter of credit, it did not absolve the bank of liability. *Id.* at 214. See also *Pringle Assoc. Mortgage Corp. v. Southern Nat'l Bank*, 571 F.2d 871 (5th Cir. 1978), where the standby letter of credit enforced by the court stated that it was to be drawn "only after the credit extended under a letter of credit on the same project by [another bank] has been exhausted." *Pringle* at 873 n.1. Cf. *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank*, 493 F.2d 1285 (9th Cir. 1974).

162. *Johnston v. State Bank*, 195 N.W.2d 126, 128 (Iowa 1972).

letter.”<sup>163</sup> What the court meant by a “direct promise” could be restated in commercial letter of credit parlance as a promise conditioned solely upon the presentation of documents and not upon the occurrence of facts or events, such as a “paramount lien” being obtained or a construction being completed in accordance with certain plans and specifications.

Similarly, in *Dodge Motor Trucks Co., Inc. v. First National Bank*,<sup>164</sup> the following operative language was held insufficient:

[W]e do have a commitment to . . . that will take care of his needs.

While we are not able to set a specific amount I am sure that we will be able to handle any purchase he may make from your firm.<sup>165</sup>

While the Court of Appeals’ reasoning in this case was, as pointed out by Professor Ellinger, circular and unconvincing,<sup>166</sup> the decision was nonetheless supportable because of the issuing bank’s failure to formulate a definite promise to pay to the beneficiary.<sup>167</sup>

In conclusion, while the number of decisions upholding questionable language in standbys far outnumbers those denying enforceability, it would be foolhardy to assume that the principle of *contra proferentem* invariably reigns supreme. Standby draftsmen should therefore avoid language which, in the words of the *Wichita Eagle* court, requires the bank to do more than deal in documents. In addition, the references to the underlying contract in the text of the standby should be limited solely to the contract reference number or date.<sup>168</sup>

## 2. Designation and Status of Beneficiary

The question of who can act as the beneficiary or as the party entitled to tender the documentary draft or demand for payment in a standby is particularly relevant given the transactional context of standbys, especially standbys of the simple demand type. Since the bank is supposed to pay upon presentation of documents, which in many instances are drawn by the beneficiary himself, one of the few valid defenses available to the issuing bank is whether the person requesting payment is factually or legally entitled to such payment.<sup>169</sup> Factual questions as to the person or entity

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163. *Id.* at 130.

164. 519 F.2d 578 (8th Cir. 1975).

165. *Id.* at 580.

166. Ellinger, *Standby Letters of Credit*, 6 INT’L BUS. LAW. 604, 616 (1978).

167. *Id.*

168. See the 1981 proposed revision to the U.C.P., note 15 *supra*, in I.C.C. Doc. No. 470/391 (Dec. 9, 1981), Gen. Provision (c): “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, *even if the reference number and/or the date of such contract is indicated in the credit.*” A subsequent version of this provision is more tolerant of references to the underlying contract by stating in the text corresponding to that italicized above: “even if any reference whatsoever to such contract is included in the text.” I.C.C. Doc. No. 470/394 Bis. (Apr. 19, 1982). This writer finds the earlier proposed revision preferable for reasons given in the principal text.

169. See *Corporacion de Mercadeo Agricola v. Mellon Bank Int’l*, 464 F. Supp. 88 (S.D.N.Y. 1978). See also *American Bell Int’l v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979), where one of the customer’s contentions was that the demand of payment by “The Government of Iran Ministry of Defense, successor to the Imperial Government Ministry of War” was not the same as by “The Imperial Government of Iran Ministry of War.” *Id.* at 423. As pointed out by the author of Note, *A Reconsideration of American Bell International, Inc. v. Islamic Republic of Iran*, 19 COLUM. J. TRANSNAT’L L. 301, 318 (1981), the beneficiary of the U.S. bank’s credit re-

designated as beneficiary are usually resolved by resorting to verifiable means of identification. Further, if the identifying document or photograph is fraudulent, the bank is protected by the disclaimer of article 9 of the U.C.P.<sup>170</sup> or, when forewarned by the customer, by the procedures set forth in section 5-114 of the U.C.C.<sup>171</sup>

Legal questions, however, are considerably more troublesome. Even the seemingly trouble-free statement "payment to be made to an authorized officer of the XYZ corporation" gives rise in practice to questions such as whether boards of directors' resolutions or minutes of meetings of shareholders need be presented in order to verify authority.<sup>172</sup> One may surmise the perplexity of a banker if prior to payment of, say, a promissory note in a financial standby, he had to establish that the payee was a holder in due course of the note so as to be entitled to the same payment as the beneficiary. In this connection, the decision in *Bank of North Carolina v. Rock Island Bank* is highly instructive.<sup>173</sup> When first heard by the United States Court of Appeals for the Seventh Circuit, the case was remanded to the United States District Court of Illinois, which entered judgment for defendant bank.<sup>174</sup> On appeal again before the Seventh Circuit, the decision of the district court was reversed.

The circuit court deemed established that the defendant bank had obtained substantial deposits from a J. Sumner because of the efforts of the beneficiary (Lorraine Company), and that the defendant bank issued the letter of credit to the beneficiary possibly in lieu of a straight loan to the beneficiary because of the likelihood that such a loan would exceed the Illinois fifteen percent per customer lending limit.<sup>175</sup> The court also accepted as facts that, with Sumner's help—which included placing substantial certificates of deposit with the Bank of North Carolina—this bank extended Lorraine a \$400,000 loan documented by a two-year promissory note made payable to Sumner and endorsed to the Bank of North Carolina. The Bank of North Carolina subsequently discounted the note and gave Lorraine \$354,000. Although the note was dated June 5, 1969, the negotiation did not take place until July 31, 1969, possibly to avoid North Carolina's usury ceiling which applied prior to July 2, 1969.

On these facts the district court held that the Bank of North Carolina

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maintained Bank Iranchar. Yet the ultimate beneficiary was obviously the person or entity entitled to present the demand for payment.

170. U.C.P. *supra* note 15, at art. 9:

Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence, of the goods represented thereby, or for the good faith or acts and omissions, solvency, performance or standing of the consignor, the carriers or the insurers of the goods or any other person whomsoever.

171. For a comparative discussion of the procedures set forth in U.C.C. § 5-114, see KOZOLCHYK, *INTERNATIONAL ENCYCLOPEDIA*, *supra* note 5, at 116-34.

172. See cases cited in note 169 *supra*.

173. 570 F.2d 202, 204 (7th Cir. 1978), *rev'd following remand*, 630 F.2d 1243 (7th Cir. 1980).

174. 630 F.2d 1243 (7th Cir. 1980).

175. *Id.* at 1246-47, 1250-51. All types of Illinois letters of credit were at that time exempt from Illinois lending limits. See *id.* at 1250-51.

was not entitled to payment on the note because it did not carry its burden to prove that it was a holder in due course. In addition, the district court held that as a "co-originator" of the note, the Bank of North Carolina should be deemed to have notice of all matters affecting the transaction, including the violation of North Carolina's usury and Illinois' lending limit statutes. In reversing the district court, the court of appeals decided that while U.C.C. article 5 set forth the issuing bank's duty to pay to the person "entitled to honor"<sup>176</sup> under section 3-307(3), a holder of a promissory note whose signature is undisputed is entitled to recover and does not bear the burden of proving its status as a holder unless the payor-defendant establishes a defense.<sup>177</sup> Once a defense is established, the burden shifts to the holder to show that he is a holder in due course. At the same time, however, the court of appeals held that for purposes of section 5-103, the Bank of North Carolina was acting as the beneficiary entitled to honor.<sup>178</sup> Further, if an ambiguity existed in the text of the letter of credit as to the status of the beneficiary, *contra proferentem* required that it be interpreted against the issuer.<sup>179</sup> This interpretation was provided without discarding the Bank of North Carolina's status as a holder in due course under section 3-307 "given the importance of 3-307 to the Code's policy of encouraging the use of commercial paper."<sup>180</sup> And, since the district court did not decide that the note itself was usurious, and the letter of credit *per se* did not violate the Illinois lending limits, those defenses were insufficient to shift the burden of proving the Bank of North Carolina's status as a holder to the plaintiff. Thus, while it was true that the North Carolina bank was a co-originator of the note, such a status, in the absence of a valid defense, did not imply a loss of the status of a holder of the note or a reversal of the burden of proving that it was a holder in due course.

### 3. *The Status of Beneficiary and Holder in Financial Standbys*

While the court of appeals' logic in characterizing the Bank of North Carolina as a beneficiary (for article 5 purposes) and holder in due course (for article 3 purposes) may appear contrived, it is nonetheless symptomatic of the conceptual problems created by the status of beneficiary in financial standbys. The purpose of many a financial standby is to allow

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176. See KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 116-34.

177. U.C.C. § 3-307 (Burden of Establishing Signatures, Defenses and Due Course) states:

(1) Unless specifically denied in the pleadings each signature on an instrument is admitted. When the effectiveness of a signature is put in issue

(a) the burden of establishing it is on the party claiming under the signature; but

(b) the signature is presumed to be genuine or authorized except where the action is to enforce the obligation of a purported signer who has died or become incompetent before proof is required.

(2) When signatures are admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defense.

(3) After it is shown that a defense exists a person claiming the rights of a holder in due course has the burden of establishing that he or some person under whom he claims is in all respects a holder in due course.

178. Bank of N.C. v. Rock Island Bank, 630 F.2d at 1249.

179. See Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 466 (2d Cir. 1970) for an influential formulation of the *contra proferentem* rule in letter of credit law.

180. Bank of N.C. v. Rock Island Bank, 630 F.2d at 1249.

someone other than the original beneficiary to present the unpaid promissory note or documentary draft to the issuing bank as if he were the beneficiary.<sup>181</sup>

It should be remembered that in a commercial letter of credit only the original beneficiary, if it is a non-transferable credit, or the second beneficiary if the credit is transferable, is entitled to tender the documents that will prompt the issuing bank's payment.<sup>182</sup> Yet, where a bank issues a financial standby promising to pay the beneficiary and the holder of the unpaid promissory note, draft or demand for payment, the bank also extends the promise to receive the tender of documents to whomever the original beneficiary transfers the note, draft or demand for payment and accompanying documents, if any. This differs from the promise in the circular-negotiation type of commercial letter of credit (whose language of negotiation, incidentally, is nonetheless usually incorporated in the text of the financial standby)<sup>183</sup> because the negotiation contemplated in the circular commercial letter of credit is of the draft only.<sup>184</sup> It does not presuppose the transfer of the right to tender the documents that comply with the text of the credit, a right which, most often, is exercised by the beneficiary prior to negotiating the draft. The type of financial standby under question also differs from the assignment of the proceeds of the commercial letter of credit because proceeds presuppose an exercised right.<sup>185</sup> Proceeds come about only as a result of a previous payment or of a right to payment earned by performance. Thus, an assignment of commercial letter of credit proceeds presupposes what the transfer of beneficiary's rights in a standby does not, i.e. that the bank's payment has been already earned by the beneficiary's performance or, more technically, by his compliance with the terms of the credit. In fact, as pointed out by Professors Eberth and Ellinger, unless one of the proposed views of the right to tender is adopted or the beneficiary grants to the assignee of proceeds a power of attorney to present the documents, the assignee of a beneficiary who has

181. See *Shaffer v. Brooklyn Park Garden Apartments*, 311 Minn. 452, 250 N.W.2d 172 (1977), for a variation of the practice described in the principal text. In the *Shaffer* case, the standbys themselves were pledged with the lender of the beneficiary. In a well-reasoned decision, the Supreme Court of Minnesota concluded that where the letters of credit did not expressly state that they were transferable, the beneficiary could not by pledging them invest the pledgee bank with the right to draw drafts, but only with the right to receive proceeds thereunder. *Id.* at 457, 250 N.W.2d at 177.

182. See *id.*; U.C.C. § 5-116; U.C.P. *supra* note 15, at art. 46(f).

183. See *Bank of N.C. v. Rock Island Bank*, 630 F.2d at 1246. There the issuing bank's promise was the following:

We hereby issue to Lorraine Realty Corp. . . . our irrevocable and unconditional commitment to purchase your Promissory Note of this date in the amount of . . . , said Promissory Note to bear a maturity date of June 5, 1971. We will purchase such Promissory Note from its holder in due course at maturity provided the holder . . . gives us at least 60 days written notice of its intent to sell to us prior to delivery date said delivery date not to be prior to maturity date . . . .

*Id.* It is important to note the affirmative duty of written notice imposed on the holder of this standby note.

184. "We hereby agree with the drawers, endorsers and bona fide holders that this credit will be duly honored on presentation." *Id.* Compare this language with that of the typical negotiation form in *Kozolchik*, *supra* note 8, at 702.

185. See U.C.C. § 5-116(2) & (3). See also U.C.C. § 9-306 which defines the secured party's proceeds in terms of rights earned by performance.

not yet tendered bears the risk of the beneficiary's whimsical or malicious refusal to tender the documents.<sup>186</sup>

The difference between the financial standby and related commercial letter of credit institutions, however, is not one predicated upon the distinction between concepts such as *Gestaltungsrecht* or *Obliegenheit*, or even among the more pedestrian "rights," "duties" and "conditions precedent."<sup>187</sup> It is predicated on the business need for a promise realizable by someone in a position to prove his or the beneficiary's financial loss in a manner easily and objectively verifiable by the issuer of the promise. Such a realization can, and frequently does, entail more than acting as a messenger-presenter of the original beneficiary's documents, as it may require the presenter's own documentation. The financial standby, however, is not issued taking into account the beneficiary's personal qualifications or the quality of his performance, as is the promise of a commercial letter of credit. All the financial standby beneficiary is expected to do is to advance monies or suffer a documentarily verifiable loss of a monetary obligation. And, depending upon the context of the transaction and the parties involved, the beneficiary of a financial standby could be said to have a right or a duty to tender, and either the right or the duty could be said to be subject to a condition precedent. Vis-a-vis the issuing bank, the beneficiary's status could be that of a holder of a right; whereas, vis-a-vis his transferee, he has a duty not to interfere as well as to cooperate with the latter's tender. In addition, vis-a-vis the issuing bank, the beneficiary's right is predicated upon the condition precedent that the tender conforms with the terms of the credit; similarly, vis-a-vis the transferee, the beneficiary's duty is conditioned upon the transferee's own ability to tender in compliance with the credit. The need for the transferability of the beneficiary's right is dictated by commercial practice. Take, for example, the increasingly frequent issuance of standbys to representatives of a class of beneficiaries such as trustees representing investors in municipal obligations or policy holders of special hazard insurance.<sup>188</sup> At the time that the standby is issued, it is seldom known who will be the investor or the special hazard claimant. Further, at the time of default by the municipality or occurrence of the loss the true beneficiary is not the trustee or class representative, but rather all or some of those beneficiaries he represents. This type of issuance, therefore, requires a concept of transfer different than that in article 46 of the U.C.P., restricted as it is to only one transfer.<sup>189</sup> For even if the single transfer restriction were found desirable, each trustee would in all likelihood need to make multiple single or "partial" transfers. Here Maurice Megrah's reminder about the existence of common law transfer and

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186. Eberth & Ellinger, *Assignment and Presentation of Documents in Commercial Credit Transactions*, 24 ARIZ. L. REV. 277, 291-92.

187. *Id.* at 287-92.

188. The author is indebted for information on these contemporary financial standby practices to Janis S. Penton, Esq., Harvey Gilbert, Esq., Harvey H. Rosen, Esq., and Michael L. Wachtell, Esq., of the Los Angeles law firm of Rosen, Wachtell & Gilbert.

189. U.C.P., *supra* note 15, at art. 46.

assignment rights outside the purview of the U.C.P. is quite helpful.<sup>190</sup>

Sound judicial decisionmaking, however, will require that courts understand the transactional context and perceive the conceptual differences between commercial letters of credit and standbys. Accordingly, where a financial standby is said to be "assignable because drafts drawn under it were negotiable,"<sup>191</sup> the court is simply misunderstanding the transactions and adding to the confusion by equating two and perhaps three different concepts—assignability of proceeds, negotiation of drafts and transfer of the letter of credit itself.<sup>192</sup> Megrah's remarks could also be profitably applied to section 5-116 of the U.C.C. The terminology in this section is simply out of step with commercial, let alone standby, letter of credit practice. Credits labelled as "assignable" are virtually unknown in the United States and in international practice.<sup>193</sup> In addition, the method for assigning proceeds in section 5-116(2), including the delivery of the letter of credit to the assignee as a prerequisite for the perfection of the security interest, is no doubt effective if what the parties wanted was to perfect a security interest in a "back-to-back" transaction.<sup>194</sup> But what if the parties did not intend to perfect a security interest in the letter of credit? Or what if the original beneficiary could not give up possession of the letter of credit, as in the case of the trustee representing a whole class of beneficiary investors or insurance claimants and not just the beneficiary entitled to payment at a given time? Conceptual dogmatism or an attitude that requires squaring the transaction in question within existing statutory, judicial or doctrinal concepts as a precondition for judicial sanction is inconsistent with the growth of the emerging law. In fact, while some of the existing U.C.C. categories such as "assignable" credits may best be dealt with by ignoring them, others such as "notation credits" which heretofore have been victims of desuetude may well have to be revived to keep up with financial standby practices.<sup>195</sup>

Finally, the issue whether third-party creditors of beneficiaries or of their transferees or assignees of proceeds can claim payment of the standby credit from the issuing bank has been decided in the negative, thereby setting the limits to the status of beneficiary in the standby promise.<sup>196</sup>

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190. See Megrah, *Risk Aspects of the Irrevocable Documentary Credit*, 24 ARIZ. L. REV. 255, 263 (1982).

191. *Fidelity Bank v. Lutheran Mutual Life Ins. Co.*, 465 F.2d 211, 213 (10th Cir. 1972).

192. The confusion between assignability of the credit and negotiability of drafts can be traced to some of article 5's draftsmen. See *Pastor v. National Republic Bank*, 56 Ill. App. 3d 421, 424, 390 N.E.2d 894, 896 (1979).

193. In this writer's more than 15-year exposure to United States and foreign bankers' associations, not one single instance of "assignable" credits has been brought to his attention.

194. See U.C.C. § 5-116(2) & comment 3 (1974 version). See also *Shaffer v. Brooklyn Park Garden Apartments*, 250 N.W.2d 172 (Minn. 1977) for an illustration of the pledge mechanism in connection with an assignment.

195. See *Pringle Assoc. Mortgage Corp. v. Southern Nat'l Bank*, 571 F.2d 871, 873 n.1 (5th Cir. 1978), which contained the following stipulation: "All drafts drawn under this letter of credit must be endorsed hereon and must bear the clause 'Drawn under Southern National Bank Letter of Credit No. 009 dated 8/29/72 for the account of Forrest M. Morris, Jr. and J.L. Sellers.'" The author's conversations with bankers indicate an increasing reliance on this type of stipulation in financial standbys.

196. See *Schmidt-Tiago Constr. Co. v. City of Colorado Springs*, — Colo. App. —, 633 P.2d 533 (1981).



#### 4. *Expiration Date*

Many of the transactions underlying standby credits require that the credit have a duration exceeding one year. In addition, as indicated by Bernard Wheble,<sup>197</sup> guarantees are required in some jurisdictions to be open-ended so as not to impair the beneficiary's right to recovery when problems with the bank customer's performance are discovered at a time later than his completion of performance.<sup>198</sup> In this connection, the 1977 decision by the United States Court of Appeals of the Third Circuit in *National Surety Corp. v. Midland Bank*<sup>199</sup> is significant. The defendant, a New Jersey state bank, refused to honor the beneficiary's draft. The bank contended that New Jersey law prohibits banks from issuing letters of credit if they exceed one year in duration. The court of appeals held that the New Jersey district court erred when applying dicta from a New Jersey appellate court decision.<sup>200</sup> These dicta were deemed not binding, and the court of appeals interpreted the New Jersey statute as restricting only the period within which sight or time drafts could be drawn and paid for. The issuance of a letter of credit was, in the court of appeals' view, not subject to the one-year limitation, and even open-ended credits were held valid.<sup>201</sup> There also was evidence that the New Jersey Department of Banking considered letters of credit with automatic renewal provisions, such as drawn in the present case, to be in violation of the statutory limitation.<sup>202</sup> New Jersey's Deputy Commissioner of Banking indicated in a letter to the district court that the Banking Department would read the relevant New Jersey statute as barring both the letter of credit and the drafts drawn under it if the letter of credit exceeded one year's duration.<sup>203</sup> This letter also referred to Comptroller of the Currency's Interpretive Ruling 7.7016 which required that "the letter of credit bear a maturity date."<sup>204</sup> The court of appeals found, however, that a significant factor to be weighed by New Jersey's Banking Commissioner in promulgating rules and regulations on banking powers was "the maintenance of parity between state and national banks."<sup>205</sup> It also determined that the federal regulatory language only required a "specified expiration date" or "a definite term."<sup>206</sup> Accordingly, the court of appeals found that: "It is significant that this rule does not reflect the existence or requirement of any statutory letter of

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197. Wheble, *supra* note 7, at 307.

198. *Id.*

199. 551 F.2d 21 (3d Cir. 1977).

200. *Id.* at 35.

201. The letter of credit in question stated:

It is a condition of this letter of credit that it shall be deemed automatically extended without amendment for one year from the present or any future expiration date hereof, unless 30 days prior to any such date we shall notify you by registered letter that we elect not to consider this letter of credit renewed for any such additional period.

*Id.* at 23. The court of appeals concluded "that the statute in question, N.J.S.A. 17:9A-25(3), imposes its one-year limitation not on letters of credit but only on drafts which are drawn upon letters of credit." *Id.* at 26.

202. *Id.* at 25.

203. *Id.*

204. *Id.* at 25 n.11.

205. *Id.* at 33.

206. *Id.*

credit time limitation, regardless of whether the 'specified expiration date' or definite term is for one, five or ten years."<sup>207</sup> The regulatory parity approach adopted by the court of appeals therefore must be read as holding that a letter of credit stipulating automatic extension for a specified period of time from "the present or of any future expiration date hereof" does not violate the Comptroller's Interpretive Ruling 7.7016 or state statutes, such as New Jersey's, as inspired by federal regulation.

### C. *How Strict is Strict Compliance?*

The traditional formulation of the strict compliance rule for commercial letters of credit—a corollary of the principle of literality referred to earlier—was set forth in the 1927 English decision of *Equitable Trust Co. v. Dawson Partners*: "There is no room for documents which are almost the same or which will do just as well."<sup>208</sup> The United States Court of Appeals for the Third Circuit has been in large measure responsible for the adaptation of this principle to standby letter of credit law. The 1977 decision in *Chase Manhattan Bank v. Equibank*<sup>209</sup> answered some crucial questions. Suppose, for example, that the bank that issued a standby letter of credit payable upon presentation of a certificate indicating its customer's default was aware of such a default. Would the bank still be entitled to reject the beneficiary's tender because the term default was not mentioned in the specified certificate? The question concerns not only the principle of literality but also that of abstraction (about which more will be said in the following section). It not only calls for an answer on how strict compliance should be, but also on whether the issuing bank's knowledge of default in the underlying transaction would affect the bank's duty of payment to the beneficiary. The court of appeals held that the issuing bank's knowledge did not excuse the beneficiary's strict compliance.

The standby in question was issued by defendant Equibank to assure plaintiff Chase of the payment of a certain amount in the event its customer, Air North Associates, failed to consummate a loan agreement with Chase. The standby was payable upon presentation of a sight draft accompanied by "a certification from you (Chase) that Air North Associates has defaulted and which default has not been cured."<sup>210</sup> The letter of credit expiration date, after various amendments, was April 30, 1973. Upon the issuing bank's customer's failure to appear at Chase's offices for the closing of the loan agreement, Chase telexed Equibank requesting the payment of the amount of the standby. After an alleged phone conversation with Equibank on April 30, 1973, Chase sent a letter confirming Air North's default. Chase also sent a formal draft via normal banking channels. Equibank received Chase's tender on May 10 and dishonored the draft, alleging the late presentation of the documents.

The court of appeals found that both banks knew that Air North

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207. *Id.*

208. [1927] 27 Lloyd's L.R. 49, 52.

209. 550 F.2d 882 (3d Cir. 1977).

210. *Id.* at 884.

could have been declared in default weeks before April 27. Letters exchanged between the banks referred to items of construction not performed, but the word "default" was not used in these letters, nor did they refer to the letter of credit in question nor demand payment in accordance therewith. The district court characterized these letters as "present indications of possible default."<sup>211</sup> The court of appeals agreed with the characterization and with the lower court's insistence upon strict compliance. These findings were all the more appropriate, said the court of appeals, since the beneficiary, Chase, "must be presumed knowledgeable about banking practices."<sup>212</sup> Thus, the court of appeals put to rest the myth that only small banks tend to get sloppy with letter of credit documentation, as well as Henry Harfield's fear that "the sacred cow of equity may trample the tender vines of letter of credit law."<sup>213</sup>

Two years later, another important question on the meaning of strict compliance in standby letter of credit law was clarified by the United States Court of Appeals for the Third Circuit in *Insurance Co. of North America v. Heritage Bank*.<sup>214</sup> Heritage Bank's standby letter of credit, issued a credit to assure a bondsman of repayment of amounts paid under the bond on behalf of Heritage bank's customer (Billings), was payable upon presentation of:

"drafts at sight accompanied by written evidence to the effect that:"

(1) "you (INA) have been called upon to make payment of loss, attorney's fees or other expenses by reason of executing an appeal Bond . . ." or that (2) "the premium thereon is unpaid and overdue" or that (3) "you (INA) have not received evidence satisfactory to you of the performance by the Principals of all its [sic] obligations in connection with the aforesaid bond was issued."<sup>215</sup>

In purported compliance with the third term of the credit, the Insurance Company of North America (INA) accompanied its draft with a demand which stated that "under the terms of that letter . . . we are enclosing our sight draft . . . and hereby certify that the liability under our bond is . . . still outstanding."<sup>216</sup> The district court dismissed INA's complaint for failure to state a cause of action. It ruled that the third term did not authorize INA's demand for payment because Billings had not become obligated to exonerate INA at any time before the conclusion of the appeal, which had not happened by the time of the demand, except where Billings failed to prosecute the appeal with effect.<sup>217</sup> The court of appeals preferred not to dwell on the above interpretation of the third term (quite possibly because it was fraught with underlying transaction considerations). Instead, the court chose to dwell on strict compliance: "For even if that condition were construed in the light most favorable to INA and it were concluded that Heritage granted INA a blank check, it is evident that

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211. *Id.*

212. *Id.*

213. *Id.* at 885 n.4.

214. 595 F.2d 171 (3d Cir. 1979).

215. *Id.* at 172.

216. *Id.*

217. *Id.* at 174.

INA did not properly fill in the blanks . . . ."<sup>218</sup>

INA conceded that after the *Equibank* decision,<sup>219</sup> there was no question concerning the application of strict compliance to standby letter of credit law, but urged the more flexible approach to documentary compliance evident in some First Circuit decisions.<sup>220</sup> The court expressed awareness of the position of other courts on tempering the strictness of strict compliance, but decided to cast its lot with the courts that feared and rejected equity's trappings.<sup>221</sup> The court of appeals admitted that it might seem harsh for INA to wind up paying the appeal bond and being left without recourse against Heritage, "which originally supplied the guaranty that induced it to sign as surety on the bond."<sup>222</sup> Yet, since INA did not produce the document called for in the credit, INA must assume responsibility for the unfortunate result. To impose the burden of loss upon Heritage Bank would impose "more than it [Heritage Bank] bargained for in the letter of credit."<sup>223</sup>

Thus, if the question were asked how strict must strict compliance be when—as in so many standby credits—the beneficiary is given a "blank check," the Third Circuit's answer is that it must still be strict. The remaining question is whether decisions such as *Equibank* and *Heritage* are irreconcilable with those that have accepted some "leaven in the loaf of strict compliance."<sup>224</sup> Contrary to appearances, it is this writer's opinion that they are reconcilable. It is also this writer's contention that such a consistency has not been more generally perceived because of a misconception of what equity is and what it does in commercial adjudication.<sup>225</sup>

Take for example a standby requiring

a "signed certified statement" by [the beneficiary] "confirming failure of Lustrelon Inc. to return moulds as per contract dated February 19, 1976 on first written demand."<sup>226</sup>

A document in purported compliance was tendered by the beneficiary confirming "failure of Lustrelon, Inc. to return moulds as per contract dated February 19, 1976, on first written demand from us."<sup>227</sup> The bank objected that this certification did not say "we certify" or "we certify and confirm." In overruling the lower court's finding that such a document failed to comply with the credit, the Superior Court of New Jersey held

218. *Id.*

219. 550 F.2d 882 (3d Cir. 1977).

220. 595 F.2d at 175 n.12, citing *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 699 (1st Cir. 1978); *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968).

221. 595 F.2d at 175.

222. *Id.*

223. *Id.* at 175-76.

224. See *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 699 (1st Cir. 1978); *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967); *First Nat'l Bank v. Wynne*, 149 Ga. App. 811, 256 S.E.2d 383 (1979).

225. For a discussion of the role of equity in commercial adjudication, see Kozolchik, *Fairness in Anglo and Latin American Commercial Adjudication*, 2 B.C. INT'L. & COMP. L. REV. 219, 242-48 (1979); Kozolchik, *The Commercialization of Civil Law and The Civilization of Commercial Law*, 40 LA. L. REV. 3, 32-47 (1979).

226. *Lustrelon, Inc. v. Prutscher*, 178 N.J. Super. 128, 141, 428 A.2d 518, 524 (1981).

227. *Id.*

that U.C.P. article 33 directed the bank to accept the certificates as tendered when no definition was given as to "certification."<sup>228</sup> The court also found that when the issuing bank informed the beneficiary of the absence of certification, a supplementary copy of the original statement was typed expressing the required certification. Thus, if not in its original form, in its amended version the certification was held to comply with credit.<sup>229</sup>

Along with the preceding situation, consider a tender of documents whose demand for payment referred to the standby credit number but whose draft failed to do so. Should the failure to state the credit number in a draft in response to a routine credit stipulation requiring the marking of the bank and credit number disqualify the tender when all other documents contained such a routine marking?<sup>230</sup> The Court of Appeals of Georgia, which found the tender to be valid, relied on the First Circuit doctrine that "a variance between documents specified and documents submitted is not fatal if there is no possibility that the documents could mislead the paying bank to its detriment."<sup>231</sup>

The Georgia court also referred to the harm suffered by the integrity of transactions if courts imposed too rigid an adherence to strict compliance; particularly, because "the objective of increased dealings to the mutual satisfaction of all interested parties is to be enhanced."<sup>232</sup> As with the New Jersey decision, the Georgia court invoked the support of a U.C.P. and U.C.C. standard of verification which requires "reasonable care" from the issuer: "It would therefore appear that authorization to the issuer to make customary deviations from instructions would be an implied term of the customer issuer contract."<sup>233</sup>

The New Jersey and Georgia decisions apparently eschewed strict compliance and relied on U.C.P. "reasonable" standards of verification of compliance when construing the meaning of a beneficiary's own certification, and in accepting a draft whose only missing element was clearly caused by an oversight and was easily correctable. Yet, there is no true

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228. *Id.* at 142, 428 A.2d at 525.

229. *Id.*

230. See *First Nat'l Bank v. Wynne*, 149 Ga. App. 811, 256 S.E.2d 383 (1979), where the text of the credit read as follows:

We hereby establish our Irrevocable Letter of Credit in your favor for the account of Woods Mill, Ltd., 2630 Equitable Building, Atlanta, Georgia, 30303, up to the aggregate amount of US \$342,848.00 (THREE HUNDRED FORTY TWO THOUSAND, EIGHT HUNDRED FORTY EIGHT U.S. DOLLARS ONLY), available by your drafts drawn at sight on us marked Drawn Under The First National Bank of Atlanta Credit No. S-3753, and accompanied by the Documents specified below:

1. Your signed statement that a default has occurred on note or security deed dated January 7, 1971.

PARTIAL DRAWINGS PROHIBITED

We hereby undertake to honor all drafts drawn under and in compliance with the terms of this Credit, when accompanied by Documents as specified, if presented to us on or before August 4, 1975.

*Id.* at 812, 256 S.E.2d at 384.

231. *Id.* at 814-15, 256 S.E.2d at 385, citing *Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank*, 569 F.2d 669 (1st Cir. 1978); *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 385 F.2d 230 (1st Cir. 1967).

232. 149 Ga. App. at 815, 256 S.E.2d at 385, citing *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967).

233. 149 Ga. App. at 815, 256 S.E.2d at 386.

conflict between strict compliance and the use of reasonable care because without reasonability there simply would be no workable basis for a strict, or indeed any other, standard of compliance. Commercial letter of credit practice has shown that any banker who wishes to carry strictness to its extreme would have to reject most if not all beneficiary tenders. Is there ever any conceivable set of documents which does not contain one missing period, comma, dot, or capitalization mark?

And what of the equivalence of terms? Should a document referring to required "water" as " $H_2O$ " (or vice versa) be rightfully rejected?<sup>234</sup> In the last analysis, there is no such thing as a uniform or universally accepted meaning of strict compliance as the same term may have different meanings in the different trades involved in the letter of credit transaction.<sup>235</sup> This is, for example, why such a basic term as a "clean" bill of lading with different meanings to importer and exporter shipping companies, insurers and banks had to be given a "reasonable" meaning by the U.C.P.<sup>236</sup> Given the relative or contextual nature of strict compliance, the logical vantage point must be that of the pivotal parties, that is, the issuing and confirming banks.<sup>237</sup> As implied in the U.C.P., such a vantage point is that of a reasonable banker, a banker whose knowledge of letter of credit practices and terminology allows him to detect truly trivial deviations and who makes up his mind as to compliance solely on the basis of the documents tendered and not on what he knows about the underlying transaction or his customer's willingness or ability to reimburse him. In addition, he must act fairly toward other participants, especially banks. If, for example, a confirming bank acting as an issuing bank would have deemed the documents in compliance, then it is justified in negotiating the beneficiary's documents. Conversely, if the issuing bank acting as the confirming bank would have rejected the documents, its refusal to honor the draft and documents negotiated by the confirming bank will be upheld.

#### D. *How Abstract is the Standby Promise?*

The abstraction or independence of the issuing bank's promise in the commercial letter of credit presupposes a separation between the beneficiary and the underlying relationships.<sup>238</sup> Because of the abstraction of the bank's promise, the beneficiary is entitled to payment even when the bank's customer failed to supply the necessary funds to the bank or when consideration in the contract between the customer and the beneficiary was inadequate or insufficient.<sup>239</sup> And, once the beneficiary's draft is accepted by either the issuing or confirming bank, the holder of such a draft is immune to defenses that the bank could have raised against the benefici-

234. For examples of variations deemed minimal or insignificant by courts in various jurisdictions and legal systems, see KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 82-86.

235. *Id.* at 77, 80.

236. See, e.g., U.C.P., *supra* note 15, at arts. 7 & 8.

237. See KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 82-86.

238. See generally KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 113-16; KOZOLCHYK, *supra* note 8, at 454-83.

239. See generally KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 113-16; KOZOLCHYK, *supra* note 8, at 454-83.

ary.<sup>240</sup> The standby letter of credit has retained, in slightly modified fashion, the abstraction of the commercial letter of credit promise.

The modifications introduced by the use of standbys have to do, first of all, with the validating role of abstraction. As discussed earlier, unless the standby promise can qualify as abstract in the sense of being involved only with documents and not with verifying performance in the underlying transaction, it is *ultra vires* and invalid. Second, and as a result of the preceding feature, the abstraction of a standby implies a distinction between the defenses that can be raised by or against the issuing bank acting as a true guarantor and those that can be raised by or against the issuer of a standby credit. Third, and as a result of the centrality of fraud litigation, an exception to abstraction has been wrought by the so-called "notice" injunction rule.

### 1. *Defenses*

As the issuer of a standby credit, a bank cannot raise as a defense, for example, the fact that its promise to guarantee performance of a developer's obligation to build roadways was abandoned as a result of the developer's insolvency.<sup>241</sup> By contrast, performance guarantees are issued on the assumption that if the underlying contract is abandoned or becomes unenforceable, so will the guarantee.<sup>242</sup>

Some guarantees expressly disclaim liability for the contractor's inability to commence performance as a result of his death or insolvency, and limit liability to a performance proven to be faulty and damaging.<sup>243</sup> None of these disclaimers or defenses are available to the standby issuer. In the words of the Colorado Court of Appeals: "the transactions or contracts underlying the bank's issuance of the letter of credit have no bearing whatsoever on the bank's primary liability to the beneficiary . . . ."<sup>244</sup> Thus, the court of appeals upheld the trial court's refusal to admit evidence on the intent of the parties when issuing the credit, on the modification and

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240. See generally KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 5, at 113-16; KOZOLCHYK, *supra* note 8, at 454-83.

241. See Board of County Comm'rs v. Colorado Nat'l Bank, 43 Colo. App. 186, 187-88, 607 P.2d 1010, 1011-12 (1979), *modified*, — Colo. —, 634 P.2d 32 (1981). See also Dubuque Packing Co. v. Fitzgibbon, 559 P.2d 440, 441 (Okla. App. 1979). "Again the beneficiary is not subject to the various technical and non-technical defenses that a guarantor or surety may set up." *Id.* at 441, citing J. WHITE & R. SUMNERS, HANDBOOK OF THE LAW UNDER THE U.C.C. 240 (1972).

242. For one of the classical early twentieth century statements of the law of guaranties, including defenses available to the guarantor, see Moore, *Guaranty and Suretyship*, in I. RUSSELL, W. MOORE & C. CUTTING, LAW OF DAMAGES, GUARANTY AND SURETYSHIP AND WILLS AND ADMINISTRATION OF ESTATES 17-45 (1912) (especially at 19-20). Professor Moore distinguishes instances where the obligation of the principal debtor was void or voidable from its inception from those where it was extinguished or suspended by operation of law, such as by bankruptcy or statutes of limitation. In the former instance, the weight of authority was in favor of allowing the surety to raise the defense, whereas in the latter instance, authority was, with some exceptions, against it. For a more up-to-date account of defenses available to the guarantor, see L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP 10-11, 292-94 (1950). This author states that "When a creditor breaches his contract with the principal and varies the sureties' risk, he discharges the sureties." *Id.* at 292.

243. See *id.*

244. See Board of County Comm'rs v. Colorado Nat'l Bank, 43 Colo. App. 186, 187-88, 607 P.2d 1010, 1011-12 (1979) (citing concurring authorities), *modified*, — Colo. —, 634 P.2d 32 (1981).

ultimate abandonment of the primary contract, and on the absence of damages or injuries to the beneficiary.<sup>245</sup> The same separation of defenses is apparent in decisions dealing with standbys containing general references to the underlying contract.<sup>246</sup> Such references have been deemed "surplusage" which should not be considered in determining beneficiary compliance.<sup>247</sup> Moreover, even when the agreement between the beneficiary and the customer could have been deemed an illegal penalty provision, the standby issuer, unlike the guarantor, is held responsible for its promise as long as the tendered documents complied with the credit.<sup>248</sup>

A brief comparative excursus points up dramatically the importance of the characterization of the bank's promise as abstract. In a 1973 decision, the Paris Court of Appeals held that where a French bank counter-guaranteed a first or simple demand indemnity given by its correspondent in favor of an Egyptian beneficiary, and *force majeure* prevented performance of the underlying contract, the French bank was justified in refusing to pay.<sup>249</sup> The court agreed with the French bank's argument that in accordance with article 2036 of the French Civil Code, there is only one form of guarantee which is ancillary to the principal obligation. If the latter is unenforceable, so will be the former.<sup>250</sup>

It is not too difficult to discern the predicament of a United States confirming bank asked to pay a French bank guarantee (clothed as it usually is in irrevocable letter of credit garb) if the French guarantee is deemed subject to the principle espoused by the Paris Court of Appeals. In accordance with United States law, unless the American bank received evidence of "egregious fraud," it would have to pay even though it was aware of the disabling *force majeure*.<sup>251</sup> Yet, the French issuing bank would be justified, in accordance with French law, in refusing reimbursement. Given the likelihood of conflicts between jurisdictions where bank guarantees are deemed ancillary and standbys are deemed abstract,<sup>252</sup> it

245. *Id.*

246. See, e.g., *West Virginia Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107 (W.D. Pa. 1976).

247. *Id.*; see also *Pringle Assoc. Mortgage Corp. v. Southern Nat'l Bank*, 571 F.2d 871 (5th Cir. 1978).

248. *Prudential Ins. Co. of America v. Marquette Nat'l Bank*, 419 F. Supp. 734 (D. Minn. 1976); see also *Fidelity Bank v. Lutheran Mut. Life Ins. Co.*, 465 F.2d 211 (10th Cir. 1972).

249. *Cour d'appel de Paris*, 15 Juin 1973, *Rev. Jur. Comm.* 1973 p.273, cited by Pouillet, *Les Garanties Contractuelles dans le Commerce International*, 5 DROIT ET PRATIQUE DU COMMERCE INTERNATIONAL 387, 405-06 (1979).

250. *Id.* For a discussion of the ancillarity of the bank guarantee in French law, see Pouillet, *supra* note 249, at 405, 406. See also GAYALDA & STOUFFLET, *LA LETTRE DE GARANTIE INTERNATIONALE*, 1981 REVUE TRIMESTRIELLE DE DROIT COMMERCIAL ET ECONOMIQUE 1, 3-5. These authors distinguish the ancillary nature of the French Civil Code's "caution" and the abstract banking or commercial guarantees, a distinction they also find in German, Italian and English law. For French decisions espousing a different view on the nature of bank guarantees, see Pouillet, *supra* note 249, at 408-11; see also this author's findings as to the present uncertainty of European law at 412-18.

251. See, e.g., *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979), for adherence to the doctrine that insurrection, supervening impossibility, accidents "and other defenses to underlying contract are immaterial." *Id.* at 16.

252. The I.C.C. Rules testify to this problem: "It has also not been found practicable to deal with the complex subject of the nature of the guarantee, i.e. whether it is a primary and independent obligation or whether it is a secondary and accessory one, because of the differing approaches to the matter under various national legislations." I.C.C. RULES, *supra* note 10, at 9.



seems advisable for the U.C.P. to adopt a rule setting forth the abstract right of reimbursement of the confirming payor bank. Vis-a-vis the "ancillary" bank guarantee, the standby credit would have to be recognized as the "principal" obligation, and as is customary with such legal categories, the latter would follow the fate of the former.

## 2. *The Notice Injunction*

The recent Iranian revolution brought about considerable standby litigation, most of it centered on the allegation that the revolutionary government had actually submitted a fraudulent tender or was very likely to do so.<sup>253</sup> Accordingly, federal courts, and particularly the Second Circuit, had to wrestle with the appropriateness of the injunction remedy provided by U.C.C. section 5-114, including such thorny issues as whether it was sufficient to prove that the "fraud in the transaction" was in relation to the underlying contract or whether it was lodged in the documentary tender itself.<sup>254</sup>

The availability to the customer of an injunction against the issuing bank is, no doubt, an exception to the abstraction principle.<sup>255</sup> In the process of shaping the injunction remedy for standby credits, courts have pierced further the veil of abstraction. In various cases, issuing banks have been ordered to provide a short-term notice<sup>256</sup> to the customer allowing the customer to object to the allegedly fraudulent documents tendered by the beneficiary.

One of the corollaries of the abstraction principle has been the rule that banks ought to determine compliance only on the basis of the documentary tender and not after consulting the customer or hearing the customer's objections.<sup>257</sup> Sound as this rule is in most presentations of documents, this writer supports a careful and sparing use of the Anglo-American injunction or its counterparts in civil law countries.<sup>258</sup> In essence, the reasons are the same that support the "reasonable" approach to strict compliance advocated in the preceding section. As stated eloquently by the United States District Court for the District of Massachusetts in a 1981 decision:

The need for this exception becomes apparent when one considers the function letters of credit are designed to perform in facilitating

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253. *Itek Corp. v. First Nat'l Bank*, 511 F. Supp. 1341, 1349 (D. Mass. 1981). *Itek*, one of the latest and best reasoned injunction decisions, distinguishes cases such as *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979), where the injunction was denied, from decisions such as the instant one, where an injunction was granted. The *Itek* court found that in *KMW International*, no actual demand for payment had been made by the Iranian beneficiary.

254. *Itek Corp.*, 511 F. Supp. at 1350 (with citation of authority). See also KOZOLCHYK, *INTERNATIONAL ENCYCLOPEDIA*, *supra* note 5, at 115-34, for a comparative analysis.

255. *Itek Corp.*, 511 F. Supp. at 1350.

256. *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979) (court ordered a three-day notice); *Stromberg Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (1979) (ten-day notice); *Itek Corp. v. First Nat'l Bank*, 511 F. Supp. 1341 (D. Mass.) (preliminary injunction was granted *sine die* for an indefinite period of time).

257. See article 7 of the U.C.P. and comment thereto in KOZOLCHYK, *INTERNATIONAL ENCYCLOPEDIA*, *supra* note 5, at 79-82.

258. For a comparative analysis, see KOZOLCHYK, *INTERNATIONAL ENCYCLOPEDIA*, *supra* note 5, at 115-34.

commercial transactions. Briefly, letters of credit, including "standby" letters . . . are designed to insure that neither party enjoys the benefits of both his own and the other party's performance . . . .<sup>259</sup>

This is the same presumed bargain rationale evident in the strict compliance cases.<sup>260</sup> It is rooted in the fairness assumption that courts should not be enforcing fully fledged obligations in exchange for pseudo obligations. To be sure, the presumed bargain rationale also requires that he who knowingly and without duress is willing to grant a "blank check" to the other party should be held to the higher degree of liability implicit in his bargain, and courts seem keenly aware of this.<sup>261</sup> But even blank checks presuppose a certain bargain, particularly between immediate parties as distinguished from distant payors and holders in due course. A judicial disregard for such a bargain can only result in an abusive use of standby credits that would eventually lead to their disuse by wary customers.

### *Summary and Conclusions*

The decisional context results from disputes centered upon the peculiar features of the standby credit, including prominently, the conferral of unchecked powers upon the beneficiary. The analysis of judicial decisions since the mid-seventies indicates that courts have contributed substantially to the shaping of rules concerning the sources of the law of standbys. Both the U.C.C. and the U.C.P. have been deemed applicable, as have administrative rulings, especially by the Comptroller of the Currency. The hierarchy of these sources, however, particularly in areas of possible conflict, has not been fully worked out yet.

Courts have also contributed to the determination of the type of language that binds the issuing bank by requiring an abstract and definite or direct promise of payment to a designated beneficiary as a basis of validation. The rigors of this requirement have been tempered with equitable principles that operate to favor the enforceability of commercial promises. Courts have clarified the import of the expiration date and some of the aspects of the beneficiary's status or capacity to claim payment. But they have struggled less successfully with the characterization of the rights of

259. *Itek Corp. v. First Nat'l Bank*, 511 F. Supp. 1341, 1350 (D. Mass. 1981).

260. See text accompanying note 223 *supra*.

261. See, e.g., *American Bell Int'l v. Islamic Republic of Iran*, 474 F. Supp. 420, 426 (S.D.N.Y. 1979). "Bell, a sophisticated multinational enterprise, well advised by competent counsel, entered into these arrangements with its corporate eyes open. It knowingly and voluntarily signed a contract allowing the Iranian government to recoup its down payment on demand, without regard to cause." *Id.* at 426. Since the United States government recognized the then de facto Khomeini government, the court deemed this recognition binding on United States courts, *id.* at 423, and determinative of the Khomeini government's capacity to act as the original beneficiary in the Iranian credit. Was Bell's bargain, however, with any Iranian government, including one that would publicly express its desire to disregard obligations to the likes of American Bell International? Further, is the public law doctrine of recognition of de facto governments suitable for the determination of the propriety of replacing a private law beneficiary, including one whose personal characteristics were essential for proper compliance with both the credit and the underlying transaction?

assignees of the beneficiary's proceeds and of subsequent beneficiaries to tender documents and obtain payment. In this area, it is imperative that courts educate themselves in the analogies and distinctions with existing commercial letter of credit institutions.

The increased popularity of financial standbys requires modifications of the existing requirements in the transfer of the credit and assignment of proceeds mechanisms as set forth both in the U.C.P. and the U.C.C. Finally, most courts have applied the commercial letter of credit principles of strict compliance and abstraction to standby credits, and some have done it not mechanically but with reasonable or equitable criteria. In doing this, strict compliance and abstraction have acquired a richer meaning, which this writer finds wholly consistent not only with the nature of standby credits but also with sound commercial adjudication in developed financial markets.

