Notes

Guaranty Letters of Credit: Problems and Possibilities

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During the past 10 years, the "guaranty"[1] letter of credit has become increasingly prominent in United States banking practice.[2] The letter of credit's low cost and adaptability have led to its employment in place of such varied security devices as bid,[3] performance,[4] and payment[5] bonds, repurchase agreements,[6] and accommodation endorsements on commercial paper.[7] These new contexts, however, involve "new risks and different assumptions"[8] than those present in the "tradi-

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1. This term denotes a letter of credit used to secure performance of an obligation. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 717 (1973). Although other names have been applied to these credits, it seems worthwhile to formulate a uniform terminology to describe a transaction in which a letter of credit is employed to accomplish the ends of a contract of suretyship or guaranty. For the distinction between these two related obligations and the letter of credit, see note 66 *infra*. The conceptual differences between letters of credit and guaranties, which are beyond banks' power to issue, were at one time widely discussed. *See generally* Second Nat'l Bank v. Columbia Trust Co., 288 F. 17, 20-22 (3d Cir. 1923); Campbell, *Guaranties and the Suretyship Phases of Letters of Credit* (pts. 1-2), 85 U. PA. L. REV. 175, 261 (1936-37). It is well established today that the traditional letter of credit is not a guaranty. Verkuil, *supra* at 725.

2. Interview with Otto R. Frank, Assistant Vice President, Valley National Bank, in Phoenix, Ariz., Nov. 30, 1973.

3. *See* text accompanying note 29 *infra*.

4. *See* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973); Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332 (N.D. Cal. 1971); Victory Carriers, Inc. v. United States, 467 F.2d 1334 (Ct. Cl. 1972). *See* text accompanying note 30 *infra*.

5. *See* Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967); text accompanying note 31 *infra*.

6. *See* Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C.L.J. 7, 14 (1971).

7. *Holland Says Documented Discount Notes Peril Issuers' Equity, Subvert Monetary Policy*, The American Banker, Oct. 25, 1973, at 3, col. 2. *See also* Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market*, 22 BUS. LAW. 1105 (1967); Verkuil, *supra* note 1, at 722.

8. Verkuil, *supra* note 1, at 717.

tional"[9] letter of credit transaction. Parties to the transaction, their counsel, and ultimately the courts must come to terms with these distinctions if the guaranty credit is to serve as an effective and reliable security device.

Meeting this goal requires the development of foolproof contractual structures oriented toward the special objectives of the guaranty transaction. At the drafting stage, contracting parties must give special attention to potential trouble spots. Recent experience suggests the most pressing task is to fit each unique contractual obligation to the letter of credit's most distinctive feature—its standardized documentary format.[10] This Note will examine means of improving current guaranty credit law and practice, so that the transaction may more effectively meet the security needs of contracting parties. To this end, the guaranty letter of credit will be described and distinguished from the traditional instrument. Specific problems will be discussed in the context of recent cases involving guaranty credits, emphasizing difficulties associated with documentary compliance. Finally, solutions will be recommended which equitably accommodate the interests at stake in each problem area.

THE GUARANTY LETTER OF CREDIT: DESCRIPTION AND BACKGROUND

Essentials of the Traditional Letter of Credit

The guaranty letter of credit is best introduced by comparison with the traditional letter of credit widely used in international sales. The traditional letter of credit assures payment[11] by adding the promise of a party of known solvency, normally a bank,[12] to the buyer's promise to pay. In the standard three-party[13] sales transaction, the bank's

9. The "commercial" documentary, irrevocable letter of credit widely used in international sales will be referred to as the "traditional" letter of credit. *See* Verkuil, *supra* note 1, at 717 n.10; text & notes 11-27 *infra*. A concise introduction to the traditional transaction is provided in J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 601-39 (1972). More detailed treatment is given in H. GUTTERIDGE & M. MEGRAH, THE LAW OF BANKERS' COMMERCIAL CREDITS (1968); B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS (1966); W. WARD & H. HARFIELD, BANK CREDITS AND ACCEPTANCES (4th ed. 1958).

10. *See* text & notes 15-27 *infra*.

11. While this Note will focus on the payment aspect of the letter of credit, the instrument's financing function may be viewed as equally important. "[T]he bulk of our nearly $40 billion of annual imports is financed by letters of credit." Verkuil, *supra* note 1, at 716. *See* J. WHITE & R. SUMMERS, *supra* note 9, at 633-39.

12. Throughout this Note, the terms "issuer" and "bank" will be used interchangeably. However, issuance of letters of credit is not restricted to banks; article 5 of the *Uniform Commercial Code*, the law applicable to letters of credit in almost all United States jurisdictions, specifically envisions nonbank issuers in sections 5-102(1)(b) and (c). *See* Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1226 (5th Cir. 1973) (bank may become primarily liable in confirming a credit issued by a nonbank).

13. For the sake of simplicity, the letter of credit will be discussed in terms of three

customer (buyer) obtains an irrevocable[14] documentary letter of credit from the issuer (bank) in favor of a named beneficiary (seller).

"Documentary" refers to the conditions of payment on the letter of credit: the beneficiary must present stipulated documents with his demand for payment.[15] If the documents meet the terms of the credit,[16] the bank must pay. Once it has paid the beneficiary, the bank looks to its customer for reimbursement, turning over the documents only in exchange for payment.[17] Documentary credits should be distinguished from "clean" credits, which require only the beneficiary's draft or demand for payment.[18] The customer who requests a clean credit foregoes the protection provided by documentary compliance provisions. Credits used in international sales typically require documents of title,[19] such as bills of lading which both evidence shipment[20] and provide security for the bank during the interim between payment and reimbursement. However, if a clean credit is used, the buyer is at the beneficiary's mercy; should the beneficiary choose to draw on the credit, retain payment, and sell the goods elsewhere, the customer may be out the amount of the draft.

The unique virtues of the traditional letter of credit—its simplicity and certainty—depend on rigorous observance of certain principles.[21] First, the letter of credit must be treated as an independent obligation, distinct from the underlying contract between customer and beneficiary.[22] This means, for example, that the bank may not dishonor the

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parties: customer, bank, and beneficiary. However, the transaction may frequently involve additional correspondent banks requesting, notifying, negotiating, or making payment on a credit. B. KOZOLCHYK, *supra* note 9, at 13. See UNIFORM COMMERCIAL CODE §§ 5-103(1)(e)-(f), for definitions of advising and confirming banks.

14. An irrevocable credit may not be revoked or cancelled without the beneficiary's consent. UNIFORM COMMERCIAL CODE § 5-106(2). This should be contrasted to the revocable credit, which may be revoked at will by the issuer. The revocable credit is patently inappropriate for use in the guaranty transaction, since it cannot provide assurance of payment. *Id.* § 5-106(3). *See generally* B. KOZOLCHYK, *supra* note 9, at 372-86.

15. UNIFORM COMMERCIAL CODE § 5-114; W. WARD & H. HARFIELD, *supra* note 9, at 36.

16. UNIFORM COMMERCIAL CODE § 5-114(1); *see* Comment, *An Issuing Bank's Duty of Payment Under an Irrevocable Letter of Credit: Asociación de Azucareros de Guatemala v. United States National Bank of Oregon*, 12 ARIZ. L. REV. 835 (1970).

17. UNIFORM COMMERCIAL CODE § 5-114(3).

18. W. WARD & H. HARFIELD, *supra* note 9, at 36.

19. Although payment terms of traditional letters of credit frequently stipulate that documents of title be submitted, a credit can be documentary even if it requires presentation of documents other than those of title. "A 'documentary draft' or a 'documentary demand for payment' is one honor of which is conditioned upon the presentation of a document or documents. 'Document' means any paper including document of title, security, invoice, certificate, *notice of default* and the like." UNIFORM COMMERCIAL CODE § 5-103(1)(b) (emphasis added). "[T]he word 'document' is far broader than 'document of title' for the purposes of this Article." *Id.* § 5-103, Comment 2. *But see* Verkuil, *supra* note 1, at 718.

20. *See* W. WARD & H. HARFIELD, *supra* note 9, at 43.

21. *See* Harfield, *Letters of Credit*, 76 BANKING L.J. 93, 101 (1959).

22. *Id.*

seller's draft because the goods were not as specified in the sales contract. A corollary of this principle is the letter of credit commonplace, banks deal in documents, rather than in goods.[23] Banks must examine proffered documents for compliance "on their face"[24] but are not required to determine the truth or falsity of the documents' content,[25] nor to ascertain facts outside the face of the letter of credit, such as the condition of goods.[26] Finally, documents submitted must comply strictly with the terms of the letter of credit: "There is no room for documents which are almost the same, or which will do just as well."[27]

The Guaranty Letter of Credit

It should be emphasized that the term "guaranty letter of credit" may refer to a wide range of transactions[28] in which a letter of credit

23. INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS art. 8 (Brochure No. 222, 1962 rev.) [hereinafter cited as UCP]. The UCP has been called a "semi-official international codification of customs." B. KOZOLCHYK, *supra* note 9, at 86. In regard to the UCP, see generally B. KOZOLCHYK, *supra* note 9, at 83-97; Funk, *Letters of Credit: U.C.C. Article 5 and the Uniform Customs and Practice*, 82 BANKING L.J. 1035 (1965). *Cf.* W. WARD & H. HARFIELD, *supra* note 9, at 46 ("Banks cannot . . . police a sales or construction contract, but they can accommodate themselves to the desires and needs of the parties if . . . the bank's function is only to receive documents and to deal in documents rather than in facts.")

24. UNIFORM COMMERCIAL CODE § 5-109(2); UCP art. 7.

25. UNIFORM COMMERCIAL CODE §§ 5-109(2), -114(2).

26. UCP art. 9.

27. Equitable Trust Co. v. Dawson Partners, Lloyd's List L.R. 49, 52 (H.L. 1926). *See* cases cited in W. WARD & H. HARFIELD, *supra* note 9, at 49. There is, however, "some leaven in the loaf of strict construction." Banco Español de Crédito v. State St. Bank & Trust Co., 385 F.2d 230, 234 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968). Some flexibility in the rule's application is necessary, if only because bank clerks cannot be expected to read and make legal judgments about the small print boilerplate on documents such as bills of lading. See discussion note 55 *infra*. The parameters of strict compliance have been the subject of interesting analysis. *See Banco Español de Crédito v. State St. Bank & Trust Co., supra* at 234-36; B. KOZOLCHYK, *supra* note 9, at 257-80. Kozolchyk's case law analysis reveals a trend toward interpreting strict compliance somewhat flexibly where a bank sues its customer for reimbusement; a more rigorous standard prevails in suits for payment by beneficiaries, giving the bank wider discretion in deciding whether to accept documents. *Id.* at 264-76.

28. In addition to those described in the text accompanying notes 3-7 *supra* and 29-37 *infra*, a variety of other uses have been reported. In Fidelity Bank v. Lutheran Mut. Life Ins. Co., 465 F.2d 211 (10th Cir. 1972), a letter of credit served as a "stand-by deposit" of $10,500 guaranteeing customer's acceptance of a $525,000 loan commitment by beneficiary. The loan commitment stipulated, "if the loan is not completed by the borrower [bank's customer on the letter of credit] according to the terms of the commitment, said deposit shall be retained as liquidated damages." *Id.* at 212. Two additional examples are provided in Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C.L.J. 251, 254-55 (1972). In one case, a distributor of motion pictures used a letter of credit to guarantee a stipulated minimum return to the producer of a film. In the other, a letter of credit from one bank was used to assure a second bank that a loan to the first bank's customer would be repaid. For additional uses of the guaranty credit, see generally Comment, *Recent Extensions in the Use of Commercial Letters of Credit*, 66 YALE L.J. 902 (1957). It is easy to imagine a wide variety of contingent monetary obligations which could be guaranteed by letters of credit. For example, a creditworthy arrestee might find that a letter of credit could ensure his appearance in court more cheaply than a bail bond. The letter of credit might be payable upon presentation of a court clerk's affidavit that the bank's customer had failed to appear.

is used as a security device. While no paradigm case may be given, the instrument's versatility may be illustrated by various ways guaranty letters of credit can be used during the course of a construction contract. If the contract is awarded by a system of competitive bidding, bidders may be asked to post bid bonds or to place cash in escrow to guarantee their willingness to contract.[29] The awarded contract may require the contractor to ensure completion of the job by depositing cash in the amount of the contract or providing a performance bond payable on his default.[30] At the same time, the contractor might demand that the property owner ensure payment by a similar deposit or payment bond.[31] In each of these situations, the requirement of a security device can be satisfied by employment of a guaranty letter of credit—an irrevocable documentary credit with payment conditions appropriate to the nature of the transaction.[32] For example, the letter guaranteeing contractor's performance might be payable against the beneficiary-owner's affidavit evidencing the contractor's default,[33] while the credit which ensures payment to the contractor might require an architect's certificate of completion.[34]

The guaranty credit also may secure performance of a purely monetary obligation. The "documented discount note" uses a guaranty letter of credit to support the issuance of commercial paper.[35] In effect, the issuing bank serves as an accommodation endorser guaranteeing the maker's obligation to repay,[36] so that the notes may carry a lower rate of interest than market conditions would otherwise permit. As can be seen, the letter of credit is "an almost infinitely adaptable device"[37] to ensure the payment of money, and a wide range of contingent monetary obligations may be secured by guaranty credits.

The foregoing examples illustrate that when the guaranty letter of credit is considered merely as a bank's promise to pay against con-

29. *See* J. BACKMAN, SURETY RATE-MAKING 29 (1948).
30. Victory Carriers, Inc. v. United States, 467 F.2d 1334 (Ct. Cl. 1972).
31. *See* Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).
32. *See* text & notes 145-56 *infra*.
33. *Cf.* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 993-94 (N.D. Ga. 1973).
34. *See* Verkuil, *supra* note 1, at 718 n.13.
35. *Holland Says Documental Discount Notes Peril Issuers' Equity, Subvert Monetary Policy*, *supra* note 7.
36. *Cf.* Harfield, *supra* note 28, at 253. Harfield remarks that in some cases a letter of credit payable to "bearer" has been printed on the back of each note. *Id.* However, "the issuance of what is essentially one letter of credit payable to 10,000 'bearers' ignores one of the traditional aspects of letter of credit law: the requirement of a single named beneficiary." Verkuil, *supra* note 1, at 724. The letter of credit mechanism is used because "banks may not become accommodation endorsers or guarantors." *Id.* at 722. The question then arises whether a letter of credit which supports a documented note is in substance an illegal ultra vires guaranty. This issue is treated at text & notes 65-89 *infra*.
37. Verkuil, *supra* note 1, at 716.

forming documents, it is indistinguishable from the traditional sale-of-goods model.[38] But while the two transactions might be superficially similar, significant differences exist between them. The kind and quantum of risk borne by the issuer of a guaranty credit may differ substantially from that associated with the traditional transaction.[39] In addition, the underlying contract is likely to generate different documentation, necessitating changed documentary compliance procedures.[40] In traditional letter of credit practice, documentary stipulations have become highly standardized. Credits used in international sales almost invariably provide for payment against a particular array of documents: the seller-beneficiary's commercial invoice, the shipper's bill of lading, and a policy or certificate of insurance covering the goods sold.[41] Guaranty letters of credit, on the other hand, will normally be payable against a statement that the bank's customer has defaulted;[42] but the form of this statement and any additional documentation required as proof may be as diverse as the varied underlying transactions guaranty credits may secure. The most important distinction, however, lies in the *purposes* for which letters of credit may be used. The traditional letter of credit is employed to make payment in the normal course of the sales transaction. The guaranty credit, in contrast, is a security device: "the bank is, in essence, secondarily liable,"[43] for the credit will not be drawn against unless the underlying transaction goes awry.

As a practical matter, disputes are unlikely to arise as to whether a given letter of credit is to serve as a security device or perform the traditional payment function.[44] Competent and responsible bankers are well aware of the nature of the obligations they undertake; issuers

38. *Cf.* Harfield, *supra* note 28, at 258.
39. *See* text & notes 65-89 *infra.*
40. *See* Comment, *supra* note 28, at 910-11; text accompanying notes 145-87 *infra.* Because substantial improvements in traditional letter of credit practice have come about through adoption of standardized payment terms and techniques, it seems probable that further refinement of the guaranty transaction can take place in the area of documentary compliance. *See generally* UCP arts. 13-31; W. WARD & H. HARFIELD, *supra* note 9, at 169-227.
41. W. WARD & H. HARFIELD, *supra* note 9, at 36.
42. Sayre, *"Clean" Letters of Credit*, J. COMMERCIAL BANK LENDING, Sept. 1973, at 56-57; Verkuil, *supra* note 1, at 725-26.
43. Verkuil, *supra* note 1, at 725.
44. The task of characterization, however, may be made more difficult by practices such as that urged in Sayre, *supra* note 42, at 59. Sayre suggests that banks worried about the possible ultra vires implications of guaranty credits

> should avoid wherever possible any wording in the implementing document which highlights the fact that the bank is called on to pay because the customer has defaulted. In many cases the same result can be obtained without using wording of default. For example, it is as effective to say the obligation has "become payable" or that it "has not been received from any other source" as it is to invite criticism by using words of default.

Id. See text & notes 65-89 *infra,* exploring the effect of ultra vires on guaranty credits.

typically identify guaranty credits as such in their own records,[45] and higher commissions may be charged for their opening and use.[46] Surely, both the customer who requests a guaranty letter of credit and the beneficiary who accepts it in lieu of a surety bond or other security arrangement are fully cognizant of the transaction's intended effect. And courts, frequently called on to determine the intent of contracting parties, should find it easy to identify letters of credit employed to protect the parties' initial allocation of business risk.[47]

Guaranty and traditional letters of credit can and should be distinguished. Establishing clear demarcation lines between the two forms is essential to the development of a documentary security device that can effectively protect the intent of the parties. Explicitly separating the two forms at the drafting stage[48] should focus attention on problems in the use of guaranty credits, thereby encouraging refinement of practices. At the level of legal rulemaking, frank recognition of differences between guaranty and traditional letters of credit should allow formation of separate rules for each transaction, preventing "conceptual pollution" of one body of law by the other.[49]

The Guaranty Credit: An Economic Phenomenon

Why do parties turn to guaranty letters of credit instead of other security devices? One answer is the instrument's low cost to the customer,[50] which results from differences between letter of credit

45. Interview with Otto R. Frank, *supra* note 2.

46. Banks charge a negotiated commission for opening guaranty credits "whether or not drawn upon." Verkuil, *supra* note 1, at 721 n.29. *See* Comment, *supra* note 28, at 910. B. KOZOLCHYK, *supra* note 9, at 116, describes an ingenious use of the traditional letter of credit by which parties saved commission charges while using the credit to guarantee payment in an export-sale transaction. Seller and buyer planned to settle directly, but buyer provided seller with a letter of credit to be drawn on if payments were not received by a stipulated date. The parties thus obtained a "free ride" at the expense of banks gearing their charges only to draws against the credit.

47. While the occasional instrument which is neither clearly fish nor fowl may be expected to appear, the mere existence of borderline cases does not invalidate a generally meaningful distinction. *See* H.L.A. HART, THE CONCEPT OF LAW 4 (1961); *cf.* discussion note 46 *supra*.

48. See text & notes 145-56 *infra*.

49. "Conceptual pollution" occurs when courts, in attempting to reach equitable results in individual cases, erode the basic principles, *see* text & notes 21-27 *supra*, upon which letter of credit law is based. Harfield feels this risk is increased by use of the letter of credit device in unfamiliar contexts, making it likely courts will lose sight of essential requisites of the transaction. *See* Harfield, *supra* note 6, at 8, 12-14. *See also* Harfield, *supra* note 28, at 252-58. Harfield is especially critical of Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967), a case which he viewed as ignoring the principle of strict compliance in order to reach an equitable result. *See* Harfield, *supra* note 6, at 13-14. For an analysis of *Fair Pavilions* and defense of its holding, see text & notes 116-27 *infra*.

50. Interview with Otto R. Frank, *supra* note 2. It is difficult to compare the costs of guaranty letters of credit and surety bonds. In both cases, charges are individually negotiated. Verkuil, *supra* note 1, at 721 n.29; *cf.* J. BACKMAN, *supra* note 29, at 53. In the writer's experience, neither banks nor surety companies will divulge their charges or the specific criteria on which they are based.

banking and the surety business.[51] Performance bonding presents the surety with a variety of complex legal and financial decisions. The surety must appraise the risk inherent in each contract, often a highly technical undertaking.[52] Once a claim has been presented, he must first investigate and then decide whether to assume the contract, settle in whole or in part, or litigate.[53] But, opening letters of credit—whether guaranty or traditional—is viewed by bankers as an ordinary credit decision, and they generally will authorize issuance within a customer's credit line.[54] At the payment stage, the bank's only duty is the frequently mechanical task of evaluating documentary compliance.[55] Perhaps most important, the bank need not spread the risk among the guaranty credits it issues; these are treated as loans, and an occasional default is counted among the bank's total credit losses as is the default of any other loan. The guaranty letter of credit, then, represents an attempt to cut costs by substituting a standardized payment device for a highly individualized form of insurance.

LIMITATIONS OF THE GUARANTY LETTER OF CREDIT

The guaranty credit, despite its low cost and adaptability, may prove disadvantageous to parties who fail to recognize the instrument's limitations. Difficulties with guaranty letters of credit stem from two sources: failure to appreciate the inherent limitations of the letter of credit device and "breakdown,"[56] where, for a variety of reasons, the parties' initial expectations regarding the security device are thwarted. The letter of credit can serve as an effective security technique only to the extent parties recognize what letters of credit can and cannot do and plan carefully to avoid breakdowns.

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51. In regard to the surety business generally, see J. BACKMAN, *supra* note 29, at 25-61.

52. "There are relatively few risks of the same type, there is practically no sharing of experience, they are subject to extraordinary loss hazards . . . they are noncancellable, [and] losses are salvaged to a substantial degree . . . ." J. BACKMAN, *supra* note 29, at 53.

53. *See generally* P. REED, ADJUSTMENT OF PROPERTY LOSSES (2d ed. 1953).

54. Interview with Otto R. Frank, *supra* note 2. Mr. Frank was careful to point out the importance of thorough credit analysis whenever any large letter of credit issuance is being considered.

55. "The requirement that a bank examine the face of the documents does not mean that every wrinkle and crease must be studied. In effect the duty is one of scrutiny sufficient to identify the document." W. WARD & H. HARFIELD, *supra* note 9, at 58.

56. This of course assumes some dispute or default involving the underlying obligation, but the parties presumably had this possibility in mind when they included a security device in their overall plans. Thus, if the customer simply defaults and the beneficiary is paid on the guaranty letter of credit, it would be wrong to say a breakdown had transpired. Rather, the instrument has only carried out its intended function. For analysis of breakdown in the traditional transaction, see J. WHITE & R. SUMMERS, *supra* note 9, at 618.

Inherent Limitations

The letter of credit's limitations become apparent when it is compared with standard suretyship arrangements.[57] Filing a claim against a corporate surety serves only to begin a bargaining process in which the surety's investigative and financial resources are brought into play. At least in theory, the surety's expertise and its power to delay or withhold settlement should ensure that its outlay on the claim approximates the actual liability of its insured. The letter of credit, in contrast, might be described as a blunt instrument, since it lacks the precision and flexibility of the surety agreement. The letter of credit can only ensure the payment of its face amount; banks lack the inclination, the specialized knowledge, and indeed the legal power[58] to adjust property losses and guarantee completion of contracts, both of which are options available to sureties on many performance bonds.[59] For example, a guaranty letter of credit might be drawn on—because of either actual default or an honest dispute—even though a contract had been substantially completed. While no corporate surety would pay or perform beyond the extent needed for completion, the letter of credit bank must pay the face amount of the credit when the operative documents are presented. Once payment has been made, the commercial realities of the situation have changed drastically: the bank's customer is now liable to the bank for the amount paid on the credit and must recover any excess payment from the beneficiary.[60]

Breakdown

Even if parties appreciate and work within the guaranty credit's inherent limitations, unexpected events may combine with poor planning to cause a breakdown of the security arrangement. While the mere presence of a security device might be reassuring to contracting parties and their financial backers, few would disagree that, as in the case of a reserve parachute, the instrument's effectiveness can be judged only when it must be used. For a security device to serve its purpose, it is essential that the instrument not break down;[61] that is, it must not fail to protect the parties' original allocation of risk when

57. *See generally* ABA SECTION OF INSURANCE, NEGLIGENCE, AND COMPENSATION LAW, FIDELITY & SURETY LAW BIBLIOGRAPHY 1946-1971 (1972); J. BLACKMAN, *supra* note 29; L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP (1950).

58. *See* text & notes 65-89 *infra.*

59. J. BACKMAN, *supra* note 29, at 25-61.

60. Parties might limit this risk by reducing the face amount of the guaranty credit as performance progresses. Such an installment credit should not run the risk of being classified as an ultra vires suretyship, since it is specifically permitted by section 5-110 (1) of the *Uniform Commercial Code.*

61. *See* discussion note 56 *supra.*

a default on the primary obligation has occurred. The most obvious such failure takes place when a default leads the beneficiary to expect compensation from the guaranty letter of credit, but he is instead not paid. Conversely, an unjustified draw against the letter of credit may obligate the customer to reimburse the bank even though he in fact may have performed.[62] A third sort of breakdown may occur where the beneficiary uses threats of a draw against the credit to extract concessions from the customer.[63] In all these situations the parties' initial allocation of risk has been frustrated, resulting in unexpected pecuniary loss and litigation. The likelihood of breakdown, however, can be sharply reduced by recognizing the letter of credit's limitations, giving careful thought to potential pitfalls in specific transactions, and drafting accordingly. Later sections of this Note will examine procedures for minimizing the possibility of breakdown.[64]

BANK SOLVENCY, ULTRA VIRES, AND GUARANTY LETTERS OF CREDIT

It has been suggested that while the guaranty credit may meet the formal requisites of the letter of credit, the instrument is in substance a suretyship contract and thus beyond a bank's power to issue.[65] This claim should be met not by conceptual inquiry as to whether a guaranty credit is a true letter of credit[66] or, instead, an ultra vires surety agreement,[67] but by reference to the reason banks are prohibited from acting

62. An essential requisite of the letter of credit is that the customer reimburse the bank on the same terms as the bank paid the beneficiary. *See* Comptroller of the Currency, Interpretative Ruling No. 7.7016, 12 C.F.R. § 7.7016 (1972) (quoted in full at note 67 *infra*).

63. *See* text & note 103 *infra*.

64. *See* text & notes 145-56 *infra*.

65. Sayre, *supra* note 42, at 62, views restrictions on guaranties as designed to limit excessive risk-taking by banks in the surety field and "cannot accept as a conclusion from law and regulations the concept that, while the writing of conventional performance bonds and indemnities is forbidden to banks, the same speculative risks can be assumed by banks *in more absolute form* through the use of the letter of credit." *See generally* W. WARD & H. HARFIELD, *supra* note 9, at 13-52; Verkuil, *supra* note 1, at 724-27.

66. In formal terms, the surety is secondarily obligated: his duty arises upon the failure of his principal (the primary obligor) to carry out his duty to the obligee. The surety's obligation comes into being upon the existence of facts constituting default on the underlying contract. By contrast, the letter of credit is a primary obligation between bank and beneficiary; the bank need concern itself only with presentation of the operative documents, not with facts bearing on the underlying contract. W. WARD & H. HARFIELD, *supra* note 9, at 133-35.

67. The last word on the matter is Comptroller of the Currency, Interpretative Ruling No. 7.7016, 12 C.F.R. § 7.7016 (1972), which states:

> A national bank may issue its own letters of credit to or on behalf of its customers in the normal course of its business provided that the bank's obligation may legally be described as a letter of credit and not as a mere guaranty. In order to constitute a true letter-of-credit transaction, the following elements must all be present: (a) The bank must receive a fee or other valid business consideration for the issuance of its undertaking; (b) the bank's undertaking must contain a specified expiration date or be for a definite term; (c) the

as sureties: to protect bank depositors and shareholders by limiting risk enterprises.[68] Acknowledging this purpose provides a more profitable focus for inquiry: how and to what extent do guaranty letters of credit endanger the solvency of issuing banks, and what corrective measures may alleviate this risk?

Guaranty credits threaten bank solvency in three broad senses. First, bankers may underestimate the risks of the transaction[69] by assuming that guaranty credits will not be drawn on.[70] Second, even if the issuance is within a customer's normal credit limit, any default and resulting draw may be accompanied by the customer's insolvency; thus, the bank will not be reimbursed for its expenditure on the credit.[71]

> bank's undertaking must not be unlimited but be up to a stated amount; (d) the bank's obligation to pay must arise only upon the presentation of specific documents and the bank must not be called upon to determine disputed questions of fact or law; (e) the bank's customer must have an unqualified obligation to reimburse the bank on the same condition as the bank has paid.

But see Sayre, *supra* note 42, at 61:

> I suggest . . . that the Comptroller of the Currency did not intend, in promulgating a Ruling as to what a "true" letter of credit transaction is, to open up a Pandora's box of "banking" intrusions into the field of insurance, surety bonding, indemnity, or what have you, nor did he intend to suggest that such an intrusion is permissible by indirection or subterfuge.

68. *Cf.* Verkuil, *supra* note 1, at 735.

69. These risks stem from several sources. First, the bank may authorize credit beyond the customer's ability to repay. *See* discussion note 70 *infra.* Second, guaranty credits generally do not involve presentation of documents of title, so the bank lacks the security provided in the traditional transaction by title to the goods involved. *See* text & notes 40-41 *supra*; *cf.* Verkuil, *supra* note 1, at 723. Finally, the bank probably lacks the complex of legal rights which protects the interests of a true surety. Sayre, *supra* note 42, at 61. This conclusion would seem to follow naturally from the modern view that the letter of credit is a sui generis obligation, not a species of guaranty or suretyship contract. *See* Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1230-32 (5th Cir. 1973), discussed at text accompanying notes 82-86 *infra.* The true surety has rights of reimbursement, exoneration, contribution, and subrogation against its principal or cosureties. Clark, *Suretyship in the Uniform Commercial Code,* 46 Texas L. Rev. 453, 454 (1968). In contrast, the letter of credit issuer has only a right of reimbursement under section 5-114(3) of the *Uniform Commercial Code.*

70. Harfield, *supra* note 28, at 258-59, illustrates this point by an imaginary interview with a bank lending officer:

> Q. Are you prepared to approve a loan of $10,000 to the Centralized Pen Company?
> A. Certainly not. They are already heavily indebted to us and $10,000 more would put them over our lending limit.
> Q. Are you prepared to open a commercial documentary credit for them, covering $20,000 of Formosan goose quills for shipment next January?
> A. Well, no. Looking at their projected cash flow, they couldn't pay, and that would turn into a loan.
> Q. Are you prepared to open a standby credit for $10 million to guarantee performance of their bid to design a new computer for IBM?
> A. Oh, sure. That's just a standby; IBM will never use it.

71. Verkuil, *supra* note 1, at 728. Sayre, *supra* note 42, at 72, suggests this need not always result: "[I]f the letter is small, in relation to a customer's general credit worthiness, and the beneficiary is a responsible person, many types of letters of credit may . . . be issued as part of bank services." A customer's insolvency, however, is virtually certain when the credit guarantees a monetary claim on an instrument such as a documented note, which envisions that the letter of credit will not be drawn on unless the maker (bank's customer) has dishonored the note. Armstrong, *supra* note 7, at 1107. This consideration has led to the suggestion that bank regulatory authorities should adopt a more restrictive posture toward this type of obligation than toward the performance bond model. *See* Harfield, *The Sensible Use of Acceptances and Letters*

Finally, both guaranty and traditional letters of credit are normally treated as contingent liabilities not reflected on the issuer's balance sheet. Since "[t]he bank's balance sheet is the basis for determining whether it has exceeded the lending limits established to assure bank solvency,"[72] the lending limits do not prevent banks from issuing guaranty letters of credit in improvident amounts.[73]

These dangers may be mitigated by issuing banks' voluntary action, regulatory measures, or both. "[H]ard-nosed, beady-eyed credit judgment"[74] should decrease the likelihood of overly risky undertakings, and banks can control aggregate issuance of guaranty credits by voluntary observance of practices analogous to lending limits. Discussion of regulatory options also has focused on subjecting guaranty credits to lending limits.[75]

Courts confronted with claims that guaranty letters of credit are ultra vires and therefore unenforceable must recognize that at stake is the continued existence of a banking practice which has developed over the course of years in response to commercial exigencies. Once it is

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of Credit, J. COMMERCIAL BANK LENDING, Nov. 1973, at 25, 31. *See also* Fidelity Bank v. Lutheran Mut. Life Ins. Co., 465 F.2d 211 (10th Cir. 1972) (guaranty credit served as "standby deposit" payable as liquidated damages to beneficiary on customer's failure to accept beneficiary's loan commitment; customer did not complete loan due to its bankruptcy); Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 995 (N.D. Ga. 1973), discussed at text accompanying notes 98-112 *infra*.

72. Verkuil, *supra* note 1, at 727, *citing* Comptroller of the Currency, Interpretative Ruling No. 7.1160, 12 C.F.R. § 7.1160 (1972).

73. The "Intra Bank Affair," described in Verkuil, *supra* note 1, at 728-33, illustrates the difficulties that may be caused by unrestricted issuance of guaranty letters of credit. Intra Bank was a Lebanese bank with a branch in New York City. The branch operated under a New York statutory scheme, designed to protect depositors in New York branches of foreign banks, which required that the bank hold assets equal to 108 percent of its liabilities. International financial developments caused Intra Bank to fail, and New York's superintendent of banking took over the branch. His examination revealed that the branch held assets of $2.4 million and liabilities of $2.15 million, apparently in compliance with the 108 percent rule.

All looked well for the bank's depositors until it was discovered that Intra Bank's New York branch had issued guaranty letters of credit with a total face amount of over $21 million. The credits had been issued to the United States Commodity Credit Corporation [CCC] to guarantee payment for surplus wheat exported to the Bank's middle eastern customers under the United States Export Sales Program. Since the guaranty credits were deemed contingent liabilities, they did not appear as liabilities on the bank's balance sheet.

CCC asserted claims under the credits as priority liens. The superintendent rejected the claims on two grounds: first, that the instruments were illegal guaranties, *see* text & note 79 *infra*, and, second, that "contingent liabilities" were not allowable in insolvency proceedings. Settlement resulted from the discovery that the branch's office building, worth $10 million, belonged to the bank but was not listed as an asset "[b]ecause of certain intrigues by Intra Bank's president." Verkuil, *supra* note 1, at 733 n.83. Funds generated by the sale of the building financed a compromise of CCC's claim.

74. Harfield, *supra* note 28, at 259.

75. "[L]ike any other unsecured loan, they should be subject to the bank's maximum loan limits and the maximum limits on loans to individuals." Verkuil, *supra* note 1, at 735. One suggestion for limiting guaranty credit issuances calls for defining guaranty letters of credit as acceptances for purposes of section 372 of the National Bank Act, 12 U.S.C. § 372 (1970), which limits total acceptances created for the account of any one customer to 10 percent of capital funds. *See* Harfield, *supra* note 71, at 29-30; Verkuil, *supra* note 1, at 735-36.

acknowledged that bank solvency can be safeguarded by less drastic means, the ultra vires doctrine loses force to other considerations which counsel judicial restraint in the guaranty credit area. Courts appear less well equipped than legislatures and bank regulatory agencies to decide to impose the broad restriction on banking activity entailed by the outright prohibition of guaranty credits.[76] In addition, letter of credit law has always allowed contracting parties wide discretion in their choice of arrangements,[77] a policy many authorities believe responsible for the instrument's effectiveness and serviceability.[78] Finally, the ultra vires issue is most likely to be raised as a defense by a bank[79] or its receiver[80] to a beneficiary's suit for payment on a guaranty credit. In such a situation, courts should protect parties who have acted with the expectation that the bank would not renege on its commitment. As one commentator—in a cogent understatement—has noted: "It is at least disingenuous for a bank intentionally to create a risk of reliance and then refuse to honor its obligation."[81]

The only court thus far to confront the ultra vires issue rejected the defense on the basis that guaranty letters of credit are implicitly authorized by the *Uniform Commercial Code.* In *Barclays Bank D.C.O. v. Mercantile National Bank,*[82] plaintiff Barclays had accepted a guaranty credit issued by an Atlanta, Georgia mortgage broker to guarantee repayment of loans made by Barclays to a Caribbean real estate developer. The credit was accompanied by a letter from the defendant, Mercantile National, which apparently confirmed the broker's obligation. Barclays ultimately demanded and was refused repay-

76. Banks in other countries frequently function as full-blown sureties in addition to issuing guaranty credits. This suggests that bankers in the United States could utilize the guaranty letter of credit as effectively. Interview with Otto R. Frank, *supra* note 2. *See* Verkuil, *supra* note 1, at 735; *cf.* B. KOZOLCHYK, *supra* note 9, at 637.

77. "The general principle in Article Five [of the *Uniform Commercial Code*] . . . is one of freedom of contract. This is made evident in the extensive use of the phrase 'unless otherwise agreed' . . . inserted no fewer than fifteen times in the various substantive provisions of Article Five." J. WHITE & R. SUMMERS, *supra* note 9, at 610-11, *citing* Comment, *Unless Otherwise Agreed and Article 5: An Exercise in Freedom of Contract,* 11 ST. LOUIS U.L.J. 416 (1957). *Cf.* UNIFORM COMMERCIAL CODE § 5-102, Comment 2.

78. *See, e.g.,* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 338 (N.D. Cal. 1971); UNIFORM COMMERCIAL CODE § 5-102, Comment 2; Comment, *supra* note 28, at 921 ("The growth of the letter of credit has been due in large measure to the willingness of courts to align case law with progressive commercial practice.").

79. This situation might arise because the customer who had requested the bank to issue the ultra vires guaranty would be estopped from refusing to reimburse the bank, but the bank would not be estopped from asserting ultra vires as a defense to the beneficiary's suit for payment. Verkuil, *supra* note 1, at 726; Comment, *supra* note 28, at 915 nn.48-50. *See* Awotin v. Atlas Exch. Nat'l Bank, 295 U.S. 209, 212-13 (1935); Texas & Pac. Ry. v. Pottorff, 291 U.S. 245, 260, *amended on other grounds,* 291 U.S. 649 (1934).

80. *See* discussion note 71 *supra. Cf.* Texas & Pac. Ry. v. Pottorff, 291 U.S. 245, *amended on other grounds,* 291 U.S. 649 (1934).

81. Verkuil, *supra* note 1, at 726.

82. 481 F.2d 1224 (5th Cir. 1973).

ment by the developer, the mortgage broker, and Mercantile before suing Mercantile on its alleged confirmation of the credit issued by the broker.[83]

The Court of Appeals for the Fifth Circuit found that the letter from Mercantile had indeed confirmed the mortgage broker's letter of credit. Mercantile attempted to avoid liability on several theories, one of which was that its "obligation was a guaranty and as such [was] ultra vires for a national bank."[84] This contention was disposed of quickly. The court quoted *Uniform Commercial Code* section 5-107(2): "A confirming bank by confirming a credit *becomes directly obligated* on the credit . . . as though it were its issuer . . . ."[85] The court reasoned that a confirming bank's obligation is not that of a guarantor because a confirming bank is directly obligated under the terms of the Code, while a guaranty is by definition a secondary obligation.[86] By holding a bank which had confirmed a guaranty credit directly liable "as though it were [the] issuer," the court implicitly resolved the question whether an issuer's obligation on a guaranty credit is an unenforceable ultra vires guaranty. If the confirming bank's obligation is direct, not secondary, and that obligation is the same as that of the issuer, it follows that the issuer's liability is also direct.

Ultra vires defenses have been characterized as a "function of the failure by banks to properly assess the new risks and different assumptions involved in issuing guaranty letters of credit."[87] This statement emphasizes that the effective use of guaranty letters of credit depends upon bankers' correctly gauging the risks of the transaction and adjusting their issuing practices accordingly. Since it seems likely that this can and will be done—and regulatory options are available to ensure that it is—the following discussion will assume banks can protect their own interests by accurate credit judgment[88] in the great majority of guaranty credit issuances. Focus will shift to an examination of how customers and beneficiaries can use the guaranty letter of credit as a reliable and efficient security device.[89]

83. *Id.* at 1226-27.
84. *Id.* at 1235.
85. *Id.* at 1236.
86. *Id.*
87. Verkuil, *supra* note 1, at 726.
88. Accurate credit judgment ensures that banks will be reimbursed for the vast bulk of payments made against guaranty credits. Banks also must willingly absorb occasional losses caused by mistaken credit appraisals rather than promiscuously litigating every case involving an insolvent customer. *Cf.* Verkuil, *supra* note 1, at 726:

> Current litigation over guaranty letters of credit has created a risk for the banking industry that may ultimately shake the foundations upon which the entire structure of letters of credit rests. The banking community has fought hard . . . to defend . . . the letter of credit as a reliable, indeed negotiable, promise to pay. It will continue to be "as good as cash" only so long as banks continue to treat it as such.

89. For example, breakdown as discussed herein will refer only to frustration of cus-

CONDITIONS OF COMPLIANCE

Patterns of Compliance Disputes

Discussion of guaranty letters of credit in general terms should not obscure the fact that each guaranty credit, like each traditional letter of credit, has a distinctly individual component in the documentary conditions of payment against which the bank must judge any claim on the credit. Documentary compliance is the most widely litigated issue in the law of traditional letters of credit,[90] so it is not surprising that compliance problems have figured prominently in reported guaranty letter of credit decisions.[91] Disputes involving compliance may occur at two points in the traditional transaction.[92] The first takes place when a payor bank dishonors the beneficiary's draft, asserting that the accompanying documents fail to comply with stipulations in the letter of credit. Alternatively, the bank may pay the beneficiary only to find that its customer refuses to reimburse it, claiming the bank wrongfully paid against noncomplying documents. Since payment necessarily requires matching particular documents against the standards provided in an individual letter of credit, each dispute must turn on its own facts. Minor discrepancies in documentation—"technicalities" in banking parlance[93]—may provide the pretext for a reluctant party to avoid the obligation created by the letter of credit.

All these difficulties and more may arise in the guaranty letter of credit transaction. Freedom of contract implicitly gives parties broad latitude in choosing payment provisions; however, this unfettered discretion may backfire. Since guaranty credits can secure a multiplicity of different obligations, many of which entail risks, documents, and procedures different from those of the traditional letter of credit, few clear guidelines are available to keep the draftsman on safe ground.[94]

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tomer or beneficiary expectations of the guaranty credit device. See discussion note 56 *supra*. It is assumed that the bank's interest can be adequately protected by proper credit judgment, so that the bank will be reimbursed whenever it pays against conforming documents.

90. *See, e.g.*, Caloric Stove Corp. v. Chemical Bank & Trust Co., 205 F.2d 492 (2d Cir. 1953) ("steel" v. "rolled prime steel sheets"); Banco Nacional Ultramarino v. First Nat'l Bank, 289 F. 169 (D. Mass. 1923) ("white crystal sugar" v. "Brazil white crystal sugar"); Bank of Italy v. Merchants Nat'l Bank, 236 N.Y. 106, 140 N.E. 211 (1923) ("dried grapes" v. "raisins").

91. *See* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973); Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332 (N.D. Cal. 1971); Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).

92. J. WHITE & R. SUMMERS, *supra* note 9, at 618-33.

93. B. KOZOLCHYK, *supra* note 9, at 281.

94. Where compliance practices have not become clearly standardized, it may be difficult to resist including terms of the underlying contract. *Cf.* W. WARD & H. HARFIELD, *supra* note 9, at 45-46; Harfield, *supra* note 6, at 15. This may create a variety of problems: conditions may be too complex for bank clerks to administer, *cf.* text & notes 149-50 *infra*; they may not be stated in documentary terms, *see* text & notes 128-44

As banks and contracting parties become more experienced in the use of guaranty letters of credit, standardized practices that will alleviate the uncertainty of individualized drafting may be expected to evolve. However, even if effective standardized procedures are widely adopted,[95] it is unrealistic to expect compliance disputes to disappear completely. For this reason, courts must develop "gap-filler"[96] rules which keep the broad objectives of the transaction in mind.

Three recent cases suggest the form compliance disputes involving guaranty letters of credit are likely to take. In each instance, conditions specified in the guaranty letter of credit failed to provide the certainty that the requirement of documentary compliance is intended to create. Instead, ill-considered stipulations created uncertainty—ultimately leading to litigation—by permitting parties to manipulate the letter of credit for self-serving ends. The following discussion will examine the problems dealt with in these decisions and attempt to evaluate the results reached from the perspective of improving guaranty credit law and practice.

Conditions Which Place One Party at the Other's Mercy

There can be no question that the documentary character of the traditional letter of credit is responsible for that instrument's extensive use, since the requirement of documentary compliance protects the beneficiary in a way alternative modes of payment—clean credits, money orders, and the like—cannot. Yet it is possible to imagine conditions, documentary in form, that because of careless drafting fail to provide the protection which the requirement of documents is intended to supply. For example, a buyer who procured a traditional letter of credit payable "against seller's statement that he shipped the goods" would be as fully dependent upon the seller's probity as if he had planned to pay by means of a clean credit[97] requiring no documents at all. In either case, an unscrupulous beneficiary—or one who erroneously believes he has performed—might simply draw on the credit without performing.

Surprisingly, analogous conditions apparently have become com-

infra; or the principle of separating the two contracts may be violated, *see* text & note 23 *supra* and note 127 *infra*.

95. *See* discussion note 40 *supra*.

96. A gap-filler is "a provision that supplies a term of the letter of credit arrangement when the parties have left a gap in it (intentionally or unintentionally)." J. WHITE & R. SUMMERS, *supra* note 9, at 611. Two recent cases have taken steps toward establishing such rules: Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 339-40 (N.D. Cal. 1971), discussed at text & notes 131-44 *infra*; Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 517, 227 N.E.2d 839, 842, 281 N.Y.S.2d 23, 27 (1967), discussed at text & notes 116-27 *infra*.

97. *See* text accompanying note 18 *supra*.

mon in guaranty credit practice in the United States.[98] *Dynamics Corp. of America v. Citizens & Southern National Bank*[99] involved a guaranty letter of credit payable against the beneficiary's certification "in the exercise of reasonable discretion and in good faith that [the bank's customer had] failed to carry out certain obligations of [its] under the said . . . Agreement."[100]

Several aspects of such a stipulation deserve comment. First, it is clearly documentary; a specific statement by a specified person is required, and the beneficiary's draft must be dishonored unless the documents tendered meet the terms of the stipulation. In these particulars, it differs from a clean credit, which requires only the beneficiary's draft or demand for payment.[101] Second and more important, the credit in question *functions* as a clean credit. The bank's only duty is to pay upon *presentation* of complying documents; it cannot be required to determine their truth or falsity.[102] Thus, the beneficiary can draw on the credit at will simply by submitting its own statement that the customer has defaulted. The temptation to use this power as a bargaining tool[103] or a form of self-help may be irresistible. If the customer learns of an attempted misuse of the credit beforehand, he may sue to enjoin payment,[104] but this remedy is not easily obtained.[105] Otherwise, the customer is virtually at the mercy of the beneficiary.

98. *See, e.g.*, Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1228 n.5 (5th Cir. 1973) ("When presented the draft must be accompanied by: . . . A signed statement to you to the effect that the amount for which the draft is due and payable by [bank's customer] to you on account of loans from you to it . . . are past due and unpaid despite due presentation for payment."); Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 994 n.2 (N.D. Ga. 1973), discussed at text accompanying note 100 *infra*; Victory Carriers, Inc. v. United States, 467 F.2d 1334, 1339 (Ct. Cl. 1972) ("Available by your drafts . . . accompanied by YOUR [beneficiary's] STATEMENT THAT CONDITIONS SPECIFIED IN THE . . . AGREEMENT . . . HAVE BEEN BREACHED."); Steinmeyer v. Warner Consol. Corp., 42 Cal. App. 3d 515, 517, 116 Cal. Rptr. 57, 59 (Ct. App. 1974) ("The letter of credit . . . called for payment by the bank upon presentation of the letter of credit, the promissory note and a statement by at least one of [the beneficiary's] officers that Steinmeyer [the bank's customer] had defaulted in paying the note."); *cf.* Sayre, *supra* note 42; Verkuil, *supra* note 1, at 723.

99. 356 F. Supp. 991 (N.D. Ga. 1973).

100. *Id.* at 994 n.2.

101. *See* text accompanying note 18 *supra.*

102. *See* text accompanying notes 24-26 *supra.*

103. "By putting a pressure on the principal [customer] that the guarantee otherwise is paid out the principal easily may be made more inclined to give in to beneficiary's demands when negotiating with him about modifications in the tender or in the performance of a contract already concluded." Comments by Professor Lars Hjerner on Revised Draft of March 1, 1973, INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM RULES FOR CONTRACT GUARANTEES, Document No. 460/150-470/230, at 5 (Apr. 13, 1973); *cf.* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332 (N.D. Cal. 1971).

104. UNIFORM COMMERCIAL CODE § 5-114(2); *see* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 996 (N.D. Ga. 1973); Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941), discussed at text accompanying note 157-61 *infra*. *See generally* B. KOZOLCHYK, *supra* note 9, at 281-95.

105. Enjoining payment of drafts drawn against an irrevocable letter of credit is an

The credit at issue in *Dynamics* guaranteed the plaintiff's performance of its contract to produce defense communications gear for India, the beneficiary of the letter of credit.[106] In late 1971, war broke out between India and Pakistan; the United States embargoed shipments of war materiel to the belligerents, including the equipment manufactured for India.[107] The plaintiff later learned that India planned to draw on the letter of credit[108] and thus sued to enjoin the defendant bank from paying against the credit, asking that the instrument be declared void.[109] The claim for injunctive relief was based on the plaintiff's allegation that it had performed the contract, and hence that the certification that India had submitted to draw on the letter of credit was fraudulent.[110]

The *Dynamics* court granted a preliminary injunction, carefully emphasizing that it did not undertake to adjudicate any claim on the underlying contract, but sought only to ensure "that India not be allowed to . . . run off with plaintiff's money on a *pro forma* declaration which has absolutely no basis in fact."[111] The court noted that the dispute in *Dynamics* presented greater difficulty than would a claim for injunctive relief on a traditional letter of credit: "[T]he court is faced with a certification of an unspecified breach of contract which involves mixed questions of law and fact and whose ultimate truth or falsity . . . may not be readily determined and is not the concern of the court."[112]

The problem raised in *Dynamics* is likely to reappear unless guaranty credit users develop payment stipulations which protect customers from fraudulent and overreaching claims of default. A guaranty letter of credit payable against an ex parte statement from the beneficiary can become a potent weapon in the beneficiary's hands: should a dispute develop, the threat of a draw on the credit can be used to extract concessions from the customer.[113]

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exceptional remedy. *See* B. KOZOLCHYK, *supra* note 9, at 283. An injunction against the payor bank will lie only when the beneficiary has submitted fraudulent or forged documents or there is "fraud in the transaction . . . or other defect not apparent on the face." UNIFORM COMMERCIAL CODE § 5-114(2). "In the transaction" refers to the letter of credit itself, not to collateral matters such as performance of the underlying contract. *Cf. id.* § 5-114, Comment 1.

106. 356 F. Supp. at 993.

107. *Id.* at 994.

108. *Id.* at 995.

109. *Id.*

110. *Id.* at 996.

111. *Id.* at 999.

112. *Id.*

113. *See* discussion note 103 *supra*. The obvious drawbacks of stipulations which, in effect, place one party at the other's mercy raise the question why presumably knowledgeable commercial parties would write such terms into their security arrangements. The most likely answer is simple inexperience in the use of guaranty letters of credit. Also, parties may feel that the instrument is unlikely to be drawn on, and thus neglect

Just as carelessly drawn payment terms may turn an ostensibly documentary credit into what amounts to a clean credit readily manipulated by the beneficiary, poorly drafted termination clauses[114] may have the effect of making an irrevocable credit revocable.[115] In either case, compliance provisions may be manipulated by one party, placing the other at its mercy. In *Fair Pavilions, Inc. v. First National City Bank*,[116] a letter of credit guaranteed payment to plaintiff for constructing the French pavilion at the 1964 World's Fair in New York. The credit was to terminate upon defendant bank's receipt of its customer's affidavit "to the effect that one or more of the events described in clause XV (Owner's Right to Terminate the Contract) of the [underlying] contract . . . had occurred."[117]

The bank's customer became insolvent. The beneficiary attempted to draw against the credit, but the bank refused payment, asserting that the letter of credit had been terminated. The bank had received an affidavit from the customer stating simply, "One or more of the events described in clause XV . . . have occurred,"[118] without identifying the claimed occurrence. In fact, none of the events had occurred.[119] The bank defended against the beneficiary's claim on a strong strict compliance theory. The lower appellate court accepted this view and granted summary judgment for the bank, noting that: "The condition . . . expressed [in the letter of credit] was the mere receipt of an affidavit containing an assertion that the event had occurred. . . . [the] Bank was not obliged to assume the burden of determining the accuracy of the representation . . . ."[120] The New

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to consider the ways in which the letter of credit might break down. *Cf.* discussion note 70 *supra*. An alternative explanation might be that payment terms such as those used in *Dynamics* are consciously bargained for by the party who benefits thereby. This may be true in a few instances, but it seems unlikely that most parties fully aware of the possible consequences would agree to such a one-sided arrangement.

114. *See* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 339-40 (N.D. Cal. 1971); Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 515, 227 N.E.2d 839, 840, 281 N.Y.S.2d 23, 24-25 (1967). Such provisions can only increase the likelihood of compliance disputes, since they provide an additional opportunity for disagreement: the bank can claim termination as grounds for dishonoring the beneficiary's draft and the customer, on the same basis, can refuse to reimburse a bank which has paid the beneficiary. The question arises whether normal doctrines of documentary compliance should apply in the termination context. Ease of administration suggests that the standard applicable to payment also should apply to termination, although it might be argued that the severity of termination provisions should require a stronger standard of compliance.

115. *See* discussion note 14 *supra*.

116. 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).

117. *Id.* at 515, 227 N.E.2d at 840, 281 N.Y.S.2d at 24-25.

118. *Id.* at 515, 227 N.E.2d at 840, 281 N.Y.S.2d at 25.

119. Fair Pavilions, Inc. v. First Nat'l City Bank, 24 App. Div. 2d 109, 111, 264 N.Y.S.2d 255, 258 (1965), *rev'd*, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).

120. 24 App. Div. 2d at 112; 264 N.Y.S.2d at 258-59.

York court of appeals reversed.[121] Construing the termination clause in the letter of credit together with a related provision in the underlying contract, the court concluded that the parties intended that the affidavit identify the alleged defect in performance so that the contractor-beneficiary might have an opportunity to cure it.[122] If the bank's customer were not required to specify "even in general terms"[123] which event had occurred, reasoned the court, the credit could be cancelled at will, placing "one party at the mercy of [the other]."[124] Accordingly, the court held the affidavit "insufficient on [its] face" to terminate the letter of credit[125] and granted summary judgment for plaintiff.[126]

Although the *Fair Pavilions* court protected the parties' original allocation of risk, the opinion was not without analytical defects. It is difficult to see how the affidavit could have been intended as notice to the contractor-beneficiary, since it was to be presented only to the bank and resulted in the credit's immediate termination. The decision also may be faulted for ignoring the principle which separates the bank's obligation from the underlying contract.[127] Yet, in spite of these doctrinal difficulties, the court was not far off the mark when it focused upon the incongruity of a security device that provides one party a de facto option to cancel at will. The validity of the *Fair Pavilions* decision therefore lies in its tendency to promote reliability in the guaranty credit device. Following the lower court decision, on the other hand, would have increased transactional uncertainty by encouraging parties to manipulate the letter of credit by self-serving claims for payment or termination. Where a guaranty credit's reliability has been undercut by inclusion of conditions susceptible to abuse, courts must protect the parties' intended allocation of risk by denying effect to fraudulent or overreaching submissions. *Fair Pavilions* suggests at least one means of safeguarding this interest: supplying additional terms reasonably implicit in the parties' original undertaking.

121. 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).
122. *Id.* at 517, 227 N.E.2d at 841, 281 N.Y.S.2d at 26.
123. *Id.* at 518, 227 N.E.2d at 841, 281 N.Y.S.2d at 27.
124. *Id.* at 518, 227 N.E.2d at 842, 281 N.Y.S.2d at 27.
125. *Id.* at 516, 227 N.E.2d at 840, 281 N.Y.S.2d at 25.
126. *Id.* at 518, 227 N.E.2d at 842, 281 N.Y.S.2d at 27.
127. The court made this error when it referred to a provision of the construction contract, which expressly permitted cancellation at will on payment of a certain sum, in support of its thesis that the termination clause in the letter of credit was not intended to allow cancellation at the will of one party. *Id.* at 518, 227 N.E.2d at 841-42, 281 N.Y.S.2d at 27. While implying exclusion of one term from the inclusion of others is a valid and useful technique of contract construction, it is misapplied when it overrides the principle of separating the letter of credit from the underlying contract. However, the parties to the arrangement contributed to this confusion, blurring the line between the two contracts by referring to the underlying contract in the guaranty credit. This accentuates the importance of clearly separating the two documents at the drafting stage. *See* Harfield, *supra* note 28, at 256-57.

Factual Conditions of Compliance

Though the documentary character of the letter of credit should be well known, parties may, through ignorance or oversight, make the mistake of phrasing conditions of compliance in factual, rather than documentary terms. This makes payment or termination contingent not on the bank's receipt of complying documents, but on the ocurrence or nonoccurrence of a factual event. Letter of credit issuers "deal in documents, not in facts"[128] to avoid the Pandora's box of complex factual disputes often involved in modern commercial transactions. Because they deal only in documents, bank personnel lack the competence of those whose business it is to appraise factual situations. This deficiency may be compounded where it is not clear how the bank is to determine the existence of the operative factual situation, since parties may abuse the credit by providing the bank with self-serving assertions of alleged facts.

In this sense, factual compliance standards can place one party at the other's mercy just as effectively as documentary standards which give legal effect to an interested party's ex parte assertion. The documentary provision is susceptible to abuse because the bank cannot concern itself with the truth or falsity of documents.[129] When, as in *Fair Pavilions,* termination is conditioned only on the customer's affidavit of default, the bank must withhold payment after receipt of such statement, fraudulent or not.[130] Factual conditions may be abused in the same way if the credit agreement requires the bank to accept claims of fact at face value and pay or terminate the credit upon receipt. Neither party, however, would be placed at the other's mercy if the issuer chose or were required to investigate the assertion of fact. Imposing this duty on the bank is problematic, however, because it requires the bank to deal in matters outside its competence.

Difficulties which may be created by the use of factual conditions of payment are illuminated by *Wichita Eagle & Beacon Publishing Co. v. Pacific National Bank.*[131] Defendant bank had issued a letter of credit for $250,000 to guarantee its customer's commitment to build a parking garage on land leased from plaintiff-beneficiary Wichita Eagle. The letter was payable "providing that [certain] conditions

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128. W. Ward & H. Harfield, *supra* note 9, at 46; see text accompanying note 23 *supra.*

129. *See* text & note 25 *supra.*

130. The bank's response also might be affected by its own interest. For example, an issuer might be more receptive to claims of termination if its customer were insolvent. *Cf.* Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 516, 227 N.E.2d 839, 840-41, 281 N.Y.S.2d 23, 25 (1967). *See also* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332 (N.D. Cal. 1971).

131. 343 F. Supp. 332 (N.D. Cal. 1971).

exist[ed]" when the bank received the draft.[132] The credit was to terminate, however, "upon the happening of" any of four listed events, including the city of Wichita's denial of a building permit for the garage.[133] As events developed, the bank's customer could not finance the garage and apparently had second thoughts about its undertaking. It submitted an unsupported, unsworn letter to the bank requesting that the credit be terminated because the city had refused to issue a building permit. In reality, the permit had never been denied.[134] The bank informed the beneficiary, Wichita Eagle, that the instrument had been terminated and requested that it be returned; Wichita Eagle replied that it still considered the letter of credit in effect.[135] The customer ultimately defaulted on its obligation to build the garage, and it seems to have been undisputed that events warranting payment on the credit had occurred. When Wichita Eagle drew against the credit, the bank refused honor, asserting the instrument had terminated. The district court held, however, that the credit continued in effect.[136] Noting "the rule that documents submitted incident to a letter of credit are to be strictly construed,"[137] the court concluded that:

> The bare letter from [the customer], without any accompanying documentation or other proof, cannot be held sufficient to have terminated the letter of credit. . . . Even in the absence of such documentation the Bank could have easily ascertained whether the City of Wichita had refused to issue a building permit . . . but this it did not do.[138]

The *Wichita Eagle* opinion provides a sound solution to problems stemming from the use of factual compliance provisions. It imposes a minimum standard for documentation supporting factual claims intended to induce payment[139] or termination of guaranty letters of credit. First, assertions of fact will be deemed insufficient—and may be ignored by the bank—unless accompanied by adequate supporting

132. *Id.* at 341.

133. Two of the existing conditions in the letter of credit—"failure to perform" and "cure"—called for the bank to draw legal conclusions in the course of its payment decision. *Id.* at 342. This places the bank in an untenable position, since such terms can only be explicated by resort to the underlying contract which may not be available to the bank and is legally irrelevant to its undertaking. *See* text accompanying note 22 *supra.*

134. The case may be equivocal on this point. Undoubtedly a deciding factor was the customer's failure to comply with its contractual duty to use its best efforts to obtain a permit. *See* Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 340 (N.D. Cal. 1971).

135. *Id.* at 336.

136. *Id.* at 337.

137. *Id.* at 339.

138. *Id.* at 339-40.

139. It is suggested that documents tendered to involve termination provisions be subject to the same compliance standard as documents submitted against payment provisions. *See* discussion note 114 *supra.*

documentation. The opinion does not attempt to prescribe generally the type and extent of support required; however, it is clear that an unsupported, unsworn claim may be rejected, and it can be inferred that a bank uncertain of the sufficiency of submitted documents[140] may reasonably ask for additional supporting information. Second, a bank "pays at its peril"[141] if, in the absence of adequate supporting material, it acts upon a guaranty letter of credit without making reasonable attempts to ascertain the validity of the underlying factual claims. For example, a customer might be in a strong legal position to refuse to reimburse the bank on the ground that documentation supporting the draw did not meet the *Wichita Eagle* compliance standards.

The *Wichita Eagle* court seems to rest its minimum compliance rule upon the doctrine of strict compliance.[142] This is an erroneous justification for an otherwise sound result, for documentary compliance cannot be an issue where compliance is not dependent upon documentary terms, but rather upon the occurrence of underlying facts. The validity of the *Wichita Eagle* standards lies in their departure from pure documentary operation toward providing a simple and inexpensive method of establishing the facts upon which payment or termination is conditioned. Thus, the *Wichita Eagle* rule serves to prevent fraudulent or overreaching claims of fact from exerting legally operative effect on guaranty credits containing factual compliance terms. The *Wichita Eagle* decision should be followed in cases involving such compliance provisions,[143] although careful drafting should make such

140. A submission might appear deficient for a variety of reasons. For example, documents might be unsupported, unsworn, or stated in deliberately ambiguous terms. *See* text accompanying note 118 *supra*. In addition, banks normally inform their customers of draws against letters of credit before making payment, Interview with Otto R. Frank, *supra* note 2, so it is likely that the bank would learn from one party of any defect in documents tendered by the other.

141. "If [the bank] keeps within the powers conferred it is protected in the payment of the draft. If it transgresses those limitations it pays at its peril." Laudisi v. American Exch. Nat'l Bank, 239 N.Y. 234, 239, 146 N.E. 347, 348 (1924).

142. Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 340 (N.D. Cal. 1971).

143. Use of factual conditions of compliance may lead a court to treat the instrument as something other than a letter of credit. In *Wichita Eagle*, defendant bank argued the instrument was not a letter of credit but rather a "performance bond or surety agreement." Post-trial Brief for Defendant at 12-17, Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332 (N.D. Cal. 1971). This contention was premised on the theory that letters of credit may be either clean or documentary; the bank argued that since the instrument in question was neither, it was not a letter of credit at all. The bank's theory was fashioned in this manner to permit the argument that under the law of surety bonds the beneficiary had suffered no actual damage. *Id.* The court in fact construed the instrument as a letter of credit because it was clearly denominated as such, the parties intended to enter into a letter of credit arrangement, and the bank received a standard letter of credit commission. 343 F. Supp. at 338-39. This seems to be the correct answer and should control in future factual compliance cases in view of the expansive definition of "letter of credit" in *Uniform Commercial Code* section 5-102. The bank might also have argued that if the instrument were a surety bond, it was ultra vires the bank and therefore unenforceable. *See* text & notes 65-89

instances infrequent.[144]

MAKING THE DOCUMENTARY FORMAT WORK

The preceding sections have examined two basic errors in formu-

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supra. This point, however, was not raised in either defendant's post-trial brief or the reported opinion.

144. The *Wichita Eagle* court viewed the issue of damages for wrongful dishonor of beneficiary's draft as "the most difficult question in the case." 343 F. Supp. 332, 340 (N.D. Cal. 1971). Although detailed consideration of damages relating to guaranty letters of credit is beyond the scope of this Note, the outlines of the problem may be briefly sketched.

Determining the beneficiary's damages raises questions which go to the very nature of the instrument and have occasioned a significant divergence between United States and British law. In general, the American rule limits damages to the face amount of the letter of credit plus incidental damages, UNIFORM COMMERCIAL CODE § 5-115(1), and may require the beneficiary to minimize damages. *See* Maurice O'Meara Co. v. National Park Bank, 239 N.Y. 386, 400-01, 146 N.E. 636, 640-41 (1925). The British rule awards the face amount plus reasonably foreseeable damages and imposes no duty of mitigation. *See generally* H. GUTTERIDGE & M. MEGRAH, *supra* note 9, at 182-93.

The issue of damages arose in *Wichita Eagle* because after the defendant-bank's customer had defaulted on its contract to build the parking garage, the plaintiff-beneficiary found a tenant who built a more valuable garage. The plaintiff had prayed for the face amount of the credit, as provided in *Uniform Commercial Code* section 5-115(1). The court found that the Code rule did not control, since the instrument was issued before its enactment; however, the Code was relied on because the question was one of first impression. A second option would have been to follow the leading pre-Code case, Maurice O'Meara Co. v. National Park Bank, *supra,* which established the measure of damages as the face amount less any offset resulting from the beneficiary's duty to mitigate. 239 N.Y. at 399-400, 146 N.E. at 640.

The Code also might have supported application of the *O'Meara* rule. While it imposes no express duty to mitigate, it reduces the face amount by "any amount realized by resale or other use or disposition of the subject matter of the transaction." UNIFORM COMMERCIAL CODE § 5-115(1). This rule would have resulted in the beneficiary taking nothing, since it had actually improved its position as a consequence of the customer's default. Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, *supra* at 340.

Faced with these choices, the court adopted a curious compromise pointed toward the unique facts of *Wichita Eagle.* It accepted testimony of the bank's expert that the new tenant's lease was worth $87,000 more to plaintiff than the original lease to the bank's customer and subtracted this sum from the $250,000 face amount. Thus, the decision did not require the beneficiary to mitigate damages, but it did prevent it from recovering more than it would have had the customer performed.

This result underscores the fact that the guaranty credit compounds the difficulties associated with determining the beneficiary's damages in the traditional context. The issue is problematic because considerations which support the general policy of minimizing damages—the inequity and social waste involved in making payment to parties who have suffered no actual loss—collide with unique aspects of letter of credit contract, particularly the principle which separates the credit and the underlying obligation. A bank's duty on a letter of credit is, by definition, to pay a sum certain on presentation of specified documents and not to pay an indeterminate amount which can only be ascertained by detailed inquiry into performance of the underlying contract.

As the *Wichita Eagle* court noted, the guaranty letter of credit provides "neither the liquidity nor the possibility of mitigation to be found in the sales situation." Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, *supra* at 341. The beneficiary cannot resell the documents of title, since such transactions rarely involve documents of title. *See* text & notes 40-42 *supra.* In this sense, any departure from the British policy of awarding the face amount may well create the very complexities parties chose the letter of credit to avoid. Guaranty credits supporting performance obligations are likely to be highly individualized, and ascertaining the extent of mitigation would prove difficult.

It also should be recalled that draws against guaranty letters of credit may be associated with the insolvency of the bank's customer. *See* text & note 70-71 *supra.* Where the bank must bear any loss on its own account, it is unlikely to pay the face amount if it can profit by dishonoring the draft and litigating the extent to which the beneficiary has or should have minimized his damages.

lating compliance provisions. Each of these mistakes effectively negates the letter of credit's most distinctive feature, its documentary character. Carelessness with the documentary aspects of the instrument undercuts the special virtues—reliability and low cost[145]—which originally led to its being transplanted to the suretyship context. To avoid the difficulties described above, parties must recognize the importance of documentary compliance and select documentary terms adapted to the exigencies of the underlying transaction. Careful drafting of compliance provisions should reduce the likelihood of breakdown, enabling the guaranty credit to protect the parties' original intent, expectations, and allocation of risk.

The Drafting Stage

Parties should begin by recognizing that their interests in the guaranty transaction are essentially opposed[146] and should try to strike a fair balance between the competing interests of customer and beneficiary.[147] Thus, the all-important compliance terms should not merely be supplied by one party or the bank;[148] rather, they should be considered in the bargaining process as fully as would any other aspect of the transaction. During this process, careful thought should be given to potential disputes so that compliance provisions may be fitted to the nature of the underlying contract. Termination provisions should, of course, be given the same degree of care as payment conditions. Finally, emphasis on the peril of conditions so simply drawn as to be manipulable by the parties should not obscure the fact that difficulties may be created by going to the other extreme.[149] As one letter of credit expert has remarked: "Those seasoned in the use of documentary, commercial letters of credit know that discursiveness, excessive detail, and elaborate conditions breed the controversies they are intended to avoid."[150]

Apart from these general suggestions, how can the parties and their counsel navigate between the Scylla of conditions susceptible to abuse and the Charybdis of overly detailed provisions? Two techniques merit particular attention. First, the legally operative determi-

145. *See* Comment, *supra* note 28, at 902-03; text & notes 50-55 *supra*.
146. INFORMATION, June-July 1973, at 52.
147. *Id.*
148. The bank, of course, should be encouraged to lend its expertise in the drafting process; it has a strong interest in the smooth operation of the credit and is likely to be more experienced than either party.
149. *See* UCP, General Provisions and Definitions, d: "Credit instructions and the credits themselves must be complete and precise and, in order to guard against confusion and misunderstanding, issuing banks should discourage any attempt by the applicant for the credit to include excessive detail."
150. Harfield, *supra* note 6, at 15.

nation of fact can be placed in the hands of an impartial third party.[151] For example, a guaranty credit ensuring performance of a construction contract might be payable only against the sworn statement of an independent consulting engineer that the contractor had defaulted. While such conditions are not new and are by no means "fail-safe,"[152] they are sufficiently simple to comport with the documentary framework of the guaranty credit and flexible enough to be adaptable to a variety of underlying obligations.[153] Worthy of note is the fact that many standardized documents used in the traditional letter of credit transaction—bills of lading, insurance certificates, and the like—are often supplied by third parties;[154] this factor may have the practical effect of preventing fraud, and thus may contribute to the success of this payment technique.

Second, documentary compliance provisions must be phrased in specific rather than general terms. The credit should, whenever possible, require precise allegations of specific events deemed to constitute default rather than stipulating for payment against a conclusory statement of nonperformance.[155] Precision in drafting compliance terms should contribute to reliable guaranty credit use, both by deterring overreaching and limiting the scope of honest disputes. Attempts at fraudulent or overreaching draws on the credit can be discouraged

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151. B. KOZOLCHYK, *supra* note 9, at 634; *cf.* W. WARD & H. HARFIELD, *supra* note 9, at 137.

152. J. WHITE & R. SUMMERS, *supra* note 9, at 631. Disputes also can arise over inspection certificates. *See* Banco Español de Credíto v. State St. Bank & Trust Co., 385 F.2d 230 (1st Cir. 1967) (third-party certificate challenged as not "unqualified" as required in letter of credit); Commercial Banking Co. v. Jalsard Pty. Ltd. [1972] 2 Lloyd's List L.R. 529, 533 (P.C. (N. South Wales) (letter of credit required that seller provide "Certificate of Inspection" for Christmas tree lights found electrically defective on arrival; held, "inspection certificate" implied only that goods were in "apparent good condition so far as could be seen").

153. *Cf.* INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM RULES FOR CONTRACT GUARANTEES, Document No. 460/157-470/232 (Nov. 1973 rev.) [hereinafter cited as ICC RULES]. The proposed rules are the product of a working party drawn from two ICC bodies, the Commission on International Commercial Practice and the Commission on Banking Technique and Practice.

The Comments to ICC Rules, *supra*, provide "for the possibility for the parties to have recourse to a neutral third party who would determine, on the basis of a prima facie appreciation of the concrete circumstances, whether or not the guarantee should be provisionally carried out." This proposed modification to articles 8 and 8 bis was not accepted. See ICC RULES, art. 10, providing for optional arbitration.

Perhaps the ideal third-party arbiter is the "Fair Witness" described in R. HEINLEIN, STRANGER IN A STRANGE LAND 98 (Berkeley Medallion ed. 1968):

> You know how Fair Witnesses behave.
>
> . . . .
>
> Jubal called out, "That house on the hilltop—can you see what color they've painted it."
>
> Anne looked, then answered, "It's white on this side."
>
> Jubal went on to Jill, "You see? It doesn't occur to Anne to infer that the other side is white, too. All the King's horses couldn't force her to commit herself . . . unless she went there and looked—and even then she wouldn't assume that it stayed white after she left."

154. *See generally* UCP arts. 13-31.

155. See cases cited note 98 *supra*.

by specificity, because false documentary submissions might expose their maker to civil or criminal liability for fraud or misrepresentation. If, in contrast, payment can be triggered by an expansive, but general allegation of default, a party wrongfully drawing on the credit could defend on grounds of good faith or mistake. Thus, even in case of an honest dispute, a party might be more prone to resort to the guaranty credit even though there may be some questions whether the conditions of payment had in fact occurred.

Finally, should the customer respond to the draw by suing to enjoin the bank, the court's task will be simplified if the letter of credit requires the beneficiary to allege stipulated facts constituting default. The decision to enjoin will then turn on whether the beneficiary's allegations are fraudulent. If, however, the operative documents express only legal conclusions, "mixed questions of law and fact"[156] are presented, and the court cannot avoid involvement with the underlying contract.

Minimum Compliance Standards

Although drafting practices can be expected to improve, cases may still arise in which ill-considered compliance provisions place one party to a guaranty credit at the other's mercy. In these instances, doctrines of strict compliance and separaton of the credit from the underlying contract should yield to a realistic appraisal of the equities involved. Documentary compliance, after all, is intended to protect the transaction from abuse and not to permit parties to sabotage the letter of credit by submitting fraudulent documents to the bank.

This point was clearly perceived in *Sztejn v. J. Henry Schroder Banking Corp.*[157] In that case, the plaintiff had ordered bristles from a supplier in India. Payment was to be made by a traditional letter of credit issued by the defendant bank through an Indian correspondent bank. In drawing on the credit, the supplier submitted documents which complied on their face[158] in that they described the merchandise as bristles. In fact, the supplier had not shipped bristles, but instead had sent crates of worthless rubbish.[159] Upon learning of the supplier's deception, the plaintiff sued to enjoin payment on the ground that the documents were fraudulent; the defendant bank moved to dismiss, arguing that an injunction could not issue because the correspondent bank had a legal duty to pay if the documents conformed to

156. Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 999 (N.D. Ga. 1973); *see* text accompanying note 112 *supra*.
157. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).
158. *Id.* at 723, 31 N.Y.S.2d at 636.
159. *Id.* at 720, 31 N.Y.S.2d at 633.

the terms of the credit.[160] Faced with an apparent conflict between rewarding active fraud or forcing payor banks to go behind documents challenged by their customers, the court avoided both extremes by holding that allegations that the documents themselves are fraudulent justify enjoining payment on a letter of credit. The *Sztejn* court explained its holding by stating that letter of credit doctrine "presupposes that the documents accompanying the draft are genuine . . . . [T]he principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller."[161]

Cases such as *Dynamics*, *Fair Pavilions*, and *Wichita Eagle* raise problems resembling the issue before the *Sztejn* court. In each instance, documents submitted against the letters of credit appeared to have been unjustified, if not actually fraudulent. In such situations, justice requires that the submitting party not prevail. But this result can only be reached by factual inquiry in violation of basic letter of credit precepts—the doctrines of strict compliance and the independence of the bank's obligation. *Sztejn* faced this issue squarely and resolved the impasse by creating a limited exception which operates where the customer, seeking to enjoin payment, alleges the documents are fraudulent. Once fraud has been raised, the court must examine the facts of the alleged fraud rather than the purely legal question of whether the documents comply with the terms of the credit. At the preliminary injunction stage, the customer-plaintiff need not establish fraud in a technical sense, and the standard of proof can be somewhat lower than would be needed to prevail in an action at law.[162] The basic approach of the *Sztejn* decision has withstood the test of time; the case forms the policy underpinning the *Uniform Commercial Code* section authorizing injunctive relief against payor banks.[163]

Yet, a variety of factors suggest that the injunction permitted by *Sztejn* may be a more extreme remedy than needed to resolve most compliance disputes involving guaranty letters of credit. While an injunction is presently the only satisfactory remedy[164] available to the

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160. *Id.* at 720, 31 N.Y.S.2d at 632.

161. *Id.* at 721-22, 31 N.Y.S.2d at 634.

162. *See* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 998-99 (N.D. Ga. 1973).

163. J. White & R. Summers, *supra* note 9, at 625.

164. The customer's alternative is to acquiesce in the draw and sue the beneficiary to recover the face amount. If the submission to the bank is wholly fraudulent, the beneficiary may well abscond with the funds, be judgment-proof, or the like. If the draw is occasioned by an honest dispute over performance, the customer may have to litigate the dispute on the underlying contract claim.

Another option may be available to the customer: pressuring the bank to dishonor the beneficiary's draft on some "technicality." Gilmore and Black, referring to traditional letters of credit, have remarked: "[A]t a time of sharp market breaks, a bank officer who cannot, at his customer's request, discover some technical reason for dishon-

customer facing unwarranted liability on a guaranty credit, it is a cumbersome solution when viewed from the perspective of streamlining guaranty credit law and practice. Resolving conflicts by litigation also runs counter to the quest for simplicity and economy, goals responsible for the guaranty credit's increasing use. Furthermore, guaranty credits appear more prone than the traditional credit to terminate in compliance disputes requiring court intervention. Not only do breach-of-contract allegations raise more complex questions than those before the *Sztejn* court,[165] but the common guaranty credit, operative upon an ex parte claim of default, may be more easily abused than the traditional credit payable against standardized documentation provided by third

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oring drafts is hardly worthy of the name." G. GILMORE & C. BLACK, THE LAW OF ADMIRALTY 105-06 (1957). This outcome is far from certain, however, if the documents appear to comply with the terms of the credit.

165. *See* text accompanying note 112 *supra*.

An innovative use of injunctive relief in the context of a guaranty credit dispute is found in Steinmeyer v. Warner Consol. Corp., 42 Cal. App. 3d 515, 116 Cal. Rptr. 57 (Ct. App. 1974). In that case, the plaintiff Steinmeyer had purchased securities from defendant Warner Consolidated. In connection with the purchase, Steinmeyer executed and delivered to Warner several promissory notes, one of which allowed Steinmeyer to offset "the amount of any loss, liability or damage suffered by or in connection with the provisions of this agreement [to transfer the securities]." 42 Cal. App. 3d at 517, 116 Cal. Rptr. at 59. Payment of the notes was ensured by letters of credit which were payable "upon presentation of the letter of credit, the promissory note and a statement by at least one of Warner's officer that Steinmeyer had defaulted in paying the note." *Id.* Steinmeyer subsequently notified Warner and the letter of credit issuer that he was exercising the offset rights provided in the note, on the ground that Warner had failed to disclose information which affected the value of the securities he had purchased. He then sued both Warner and the issuer, seeking not only to enjoin the bank from paying, but *to enjoin Warner from demanding payment on the credit.* The trial court granted this latter request, "prohibiting presentation to the bank of one of the documents needed to authorize payment of the letter of credit." 42 Cal. App. 3d at 518, 116 Cal. Rptr. at 59.

On appeal, the court chose to deal only with the appropriateness of enjoining the beneficiary from demanding payment. Since the issue was framed in this fashion, the court was able to avoid the problem of the separation of the letter of credit from the underlying transaction: "[A]s between Steinmeyer and Warner the letter of credit cannot be construed in isolation from the underlying agreement and the promissory note. The letter of credit was contemporaneous with the agreement and the note . . . . The several instruments must therefore be construed together." *Id.* Thus, viewing the transaction as a whole, the court concluded that the terms of the credit did not, as Warner contended, vest in Warner the "sole, unrestricted power to determine whether Steinmeyer had complied with the terms of the note." 42 Cal. App. 3d at 519, 116 Cal. Rptr. at 60. Indeed, stated the court, "[i]t would be anomalous to empower Warner to circumvent Steinmeyer's rights of offset simply by seeking payment of the letter of credit." *Id.* Accordingly, the trial court's preliminary injunction was affirmed.

Steinmeyer suggests that a customer facing an unwarranted liability on a guaranty credit might be well advised to attempt to enjoin the beneficiary from demanding payment as well as suing to enjoin the bank from paying. The reason is that in an action against the beneficiary the court should be free to consider the totality of the dealings between the parties, while in a suit to enjoin payment on a letter of credit the court's inquiry is limited to the issue of fraud in the documentary tender. See text accompanying note 161 *supra*. It should, however, be noted that the injunction against the beneficiary may be available only under limited circumstances, since it is essentially an injunction against breach of contract. For example, the defendant-beneficiary in *Steinmeyer* argued that an injunction could not issue to prevent breach of a contract which was not specifically enforceable. This contention was rejected on the basis of decisions holding that "an agreement to transfer stock of peculiar value may be specifically enforceable." *Id.* The *Steinmeyer* decision thus provides an additional legal remedy for parties ulti-

parties.[166] This increased likelihood of complex compliance disputes —coupled with the drastic nature of injunctive relief and that remedy's last-ditch nature in traditional letter of credit practice—suggests that guaranty credit law must provide some other means of resolving compliance disputes.

The outlines of such a procedure may be gleaned from *Fair Pavilions* and *Wichita Eagle*. The facts of both cases clearly suggest the falsity of documents submitted to terminate the letters of credit involved; yet the documents apparently complied in full with the terms of the credits. In this sense, the *Fair Pavilions* and *Wichita Eagle* courts faced the precise issue confronting the court in *Sztejn*: to enforce basic letter of credit principles by giving effect to conforming documents would have allowed the submitting parties to profit by their own fraud.[167] But unlike the *Sztejn* decision which attacks the problem of documentary fraud by mandating a factual inquiry into the documents' genuineness, *Fair Pavilions* and *Wichita Eagle* adopt a more oblique approach. The latter two cases resolve the dilemma by defining compliance, in the context of the credits before them, as imposing a duty beyond mere technical accuracy between the tendered documents and the terms of the letter of credit. On this basis, the *Fair Pavilions* and *Wichita Eagle* courts were able to find that the documents submitted to terminate the credits were legally insufficient to do so.

The general validity of the approach taken in *Fair Pavilions* and *Wichita Eagle*—that of imposing stricter standards of compliance where guaranty credits contain documentary conditions susceptible to abuse—is obscured by the deciding courts' failure to properly articulate the rationale of their holdings.[168] It is nonetheless useful to read the two decisions broadly, in the hope of developing general principles capable of solving problems caused by the use of "conditions which

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mately liable on guaranty letters of credit, although it would only be available in circumstances justifying the issuance of an injunction for breach of contract.

166. *See* text accompanying note 41 *supra*.

167. The two decisions also may be viewed as critical of the banks involved, which appeared all too ready to terminate guaranty credits which ensured performance by their apparently insolvent customers.

168. Although the *Fair Pavilions* opinion focuses upon the credit's termination provisions as "a drastic provision which . . . would place one party at the mercy of another" and states that such provisions are "against the general policy of the law," the court appears concerned more with the severity of the particular instrument's cancellation than with the broader problem of ostensibly documentary provisions which may be abused by fraudulent or overreaching submissions. *See* 19 N.Y.2d 512, 518, 227 N.E.2d 839, 842, 281 N.Y.S.2d 23, 27 (1967). And the *Wichita Eagle* decision is cast in terms of strict compliance, although the problem was resolved not by application of the strict compliance doctrine but by imputing additional terms to the credit in question. *See* text & notes 131-44 *supra*.

place one party at the mercy of [the other]."[169] So considered, *Fair Pavilions* indicates that documents submitted against a guaranty credit must, as a minimum, specify the precise nature of the claimed default. Absent compliance with this duty, the submission to the bank can have no legal effect. And while *Wichita Eagle* dealt with factual compliance provisions, the facts of that case amply support the broad proposition that unsupported ex parte claims upon guaranty letters of credit should not be legally operative.[170]

Implicit in this interpretation of *Fair Pavilions* and *Wichita Eagle* is the recognition that conditions which allow one party to draw on or terminate a credit at will destroy the certainty which forms the basis for the requirement of documentary compliance. Conditions of this type not only fail to protect the parties' original allocation of risk, but may even increase uncertainty by offering opportunities for fraud and other abuses, and thus allowing the credit itself to become a focus of dispute.[171] *Fair Pavilions* and *Wichita Eagle* suggest a means by which courts may prevent abuses of such compliance provisions: imposition of additional terms designed to protect the transaction's aims. Such judicially-implied provisions might be considered minimum compliance standards, since the documents' failure to comply with the additional terms would result in its being deemed legally inoperative.

While *Fair Pavilions* and *Wichita Eagle* thus might be said to contain the germ of a minimum compliance standard, courts should be wary of casual adoption of the precise terms implied in those cases. Unlike the *Sztejn* decision, which attempts to reach a generally valid solution to a potentially recurring problem, these two opinions evidence a narrow preoccupation with the particular facts presented.[172] As a consequence, the *Fair Pavilions* and *Wichita Eagle* courts, rather than seeking to formulate and apply generally applicable letter of credit principles, adopted the one-shot solution of construing given compliance terms so as to find that apparently fraudulent submissions fell outside them. Courts confronted with abuses of documentary provisions therefore should look beyond *Fair Pavilions* and *Wichita Eagle* and attempt to develop coherent doctrines capable of rectifying recurring errors in guaranty credit drafting.[173]

169. Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 518, 227 N.E.2d 839, 842, 281 N.Y.S.2d 23, 27 (1967).
170. *See* text & notes 131-44 *supra*.
171. *Cf.* text & note 103 *supra*.
172. It may be that the courts viewed the issue before them as the relatively narrow question presented by easily exercised termination provisions, overlooking the broader problem of compliance terms easily abused by self-serving submission of documents.
173. Such a system is described in the discussion of the ICC Rules at text & notes 188-213 *infra*.

The most obvious such error is the inclusion of documentary conditions which place "one party at the mercy of [the other]."[174] Where terms of this type are present, the potential for abuse is so extreme as to justify an approach resembling a presumption of noncompliance. In such cases, courts should formulate and enforce minimum compliance terms designed to ensure certainty in guaranty credit operation. Under such a system, a payor bank would have the duty to determine at the time of submission whether the credit's terms provide the protection expected of a documentary instrument or, instead, place its customer at the beneficiary's mercy. In the former case, it would pay if the documents complied on their face;[175] in the latter, the bank would request the submitting party to provide information meeting the minimum compliance standard. The minimum compliance standard might require, for example, that the party tendering documents support its allegation of default with sworn statements providing details of the claimed defalcation, showing that a demand for cure had been made upon the defaulting party and alleging that the defect in performance had not been remedied.[176] The existence of such a standard would, where applicable, justify a bank's refusal to act upon the submission until the requested information were supplied or the bank's customer acquiesced in the draw.[177] The beneficiary then would elect either to meet the minimum compliance standard by alleging specific default, notice, and failure to cure or treat its original tender as complying and sue the bank for wrongful dishonor.[178] If the beneficiary took the former course, the submission would be deemed complying, and the bank would be required to honor the beneficiary's draft[179] unless enjoined from so doing.

If the customer sued to enjoin payment, the action would be governed by existing letter of credit law. The customer's cause of action would be based on the theory that the beneficiary's assertions of de-

174. Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 518, 227 N.E.2d 839, 842, 281 N.Y.S.2d 23, 27 (1967).

175. UNIFORM COMMERCIAL CODE § 5-109(2); UCP art. 7.

176. The party against whom the claim had been lodged might be allowed a period of time in which to correct or complete his performance. If cure were not accomplished within the period, payment or termination would automatically ensure.

177. If the draw is legitimate, the submitting party should have little difficulty supplying the required information. That party also might sue for immediate payment, alleging wrongful dishonor of his drafts. In that eventuality, the court would make a preliminary determination of the compliance standards' applicability; if they were held to apply, the bank would not be required to pay unless and until the standards were met. If the standards did not apply, the bank would be under a duty to pay unless it raised the additional defense that the documents failed to comply with the terms of the credit.

178. In this situation, the court would review the correctness of the bank's determination to apply the minimum compliance standard. If the bank's decision were deemed proper, compliance with the standard would be a prerequisite to payment.

179. The bank would, under existing law, be allowed at least 3 banking days in which to make payment. UNIFORM COMMERCIAL CODE § 5-112(1).

fault, notice, and failure to cure were fraudulent or that there was "fraud in the transaction."[180] As in the traditional letter of credit context, an equity court asked to enjoin payment on a guaranty credit would be concerned only with the validity of the plaintiff's allegations of fraud; just as breach of warranty on goods shipped does not justify enjoining payment on a traditonal credit, mere technical disputes concerning performance should not suffice to deny legal effect to submissions against guaranty letters of credit. If no fraud is present—that is, if "there is a legal and factual basis"[181] for a given documentary submission—no injunction should issue.

The minimum compliance standards proposed above provide several related means for minimizing problems posed by documentary terms susceptible to fraudulent or overreaching submissions.[182] First, the standards appear to deter documentary fraud. Sworn factual claims, unlike mere legal conclusions, can be verified and may, if false, provide a basis for civil and criminal sanctions against the submitting party. Second, conditioning payment upon the receipt of factual statements serves the informative function of providing the customer with a basis for negotiation and possible resolution of the underlying dispute, as well as giving both customer and bank the facts needed to intelligently decide to honor or reject the beneficiary's submission. Finally, should the dispute be submitted for court resolution, the decision may be simplified by earlier and clearer presentation of the dispute's factual aspects. Although it is unrealistic to suggest that minimum compliance standards will prevent occurrence of egregious fraud, such standards present an effective means of deterring resort to the guaranty credit as a bargaining tool[183] or an escape from undesirable business commitments.

It is plain that the proposed minimum compliance standards represent a significant inroad upon traditional letter of credit principles.[184] Because these doctrines are responsible for the traditional instrument's simplicity and certainty, any innovation requiring their compromise must bear a heavy burden of justification.[185] Yet an examination of

180. *Id.* § 5-114(2).

181. Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 999 (N.D. Ga. 1973).

182. Note that the proposed minimum compliance standards closely resemble the suggestions for drafting guaranty credit terms presented in text & notes 146-56 *supra.*

183. *See* text & note 103 *supra.*

184. Once a particular guaranty credit has been found to embody compliance provisions susceptible to abuse by self-serving documentation, strict compliance with the credit's terms must yield to the minimum compliance doctrine, which aims to secure at least prima facie evidence of default. And, since default normally must be defined with reference to the underlying contract, the principle of the letter of credit's independence must be sacrificed as well.

185. *See* Harfield, *supra* note 6, at 15. "[T]he utility of the letter-of-credit device

the cases discussed above suggests that, under certain circumstances, minimum compliance standards may ensure reliable guaranty credit operation where traditional rules cannot. As the *Sztejn* case aptly notes, traditional credit law is predicated upon the genuineness of the overwhelming majority of documentary submissions.[186] This is the primary purpose of standardized compliance terms, which ensure genuineness by presenting obstacles to all but the most egregious sorts of fraud.[187] On the other hand, guaranty letters of credit—whether due to design, carelessness, or sheer necessity—often include terms which make the credit vulnerable to overreaching or fraudulent submissions. When basic letter of credit principles fail to ensure certainty, there exists no reason for rigid adherence to such principles. Indeed, effective letter of credit usage requires imposition of prophylactic rules to prevent abuses. In such cases, minimum compliance terms provide a relatively simple means of protecting the contracting parties' original intent. And, where a guaranty credit's terms in fact provide the certainty requisite in a documentary security device, traditional letter of credit law should be capable of fairly resolving any disputes which may arise.

PROPOSED UNIFORM RULES FOR CONTRACT GUARANTEES

The foregoing discussion has implicitly assumed that effective, economical security devices could be built upon the basic letter of credit framework, with strategic alterations to accommodate different underlying transactions. The International Chamber of Commerce [ICC] in its proposed *Uniform Rules for Contract Guarantees*[188] [ICC Rules] urges a more radical approach to an effective documentary security device. The ICC Rules clearly envision an instrument much like the guaranty letter of credit now issued by banks in the United States.[189] The proposal consists of 10 articles, which are incorporated by reference into all instruments stated to be issued subject to their

depends upon close adherence to the law of commercial documentary letters of credit and . . . the continued vitality of this financial instrument is more important than the result in a particular case." *Id.*

186. Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 721-22, 31 N.Y.S.2d 631, 634 (Sup. Ct. 1941).

187. *Cf.* text accompanying note 41 *supra.*

188. *See* discussion note 153 *supra.* This version of the ICC Rules, ICC Document No. 460/168-470/244 (Aug. 5, 1974), is being considered for revision. Work on the project is scheduled to be renewed with a "different approach" within 12-18 months. Letter from Bernard S. Wheble, Chairman of the ICC Commission on Banking Technique and Practice, to John F. Battaile, Mar. 27, 1975, on file in the *Arizona Law Review* office. Although the future form of the ICC Rules is uncertain, they remain relevant to the problems discussed in this Note.

189. *See* text accompanying notes 28-49 *supra.*

terms.[190] In this respect, the rules are invoked in the same manner as the *Uniform Customs and Practice for Documentary Credits* [UCP].[191]

The proposed ICC Rules describe three principal types of guarantees: tender, performance, and repayment.[192] Each envisions a guarantor who will make payment to a beneficiary should the guarantor's principal default on his obligation to the beneficiary.[193] The tender guarantee amounts to a bid bond, providing for payment in the event the principal defaults on the obligations resulting from submission of the tender.[194] The performance guarantee specifically applies to construction obligations, although the form might be used to cover a wide variety of performance obligations.[195] The repayment guarantee ensures payment of "sums advanced or paid by the beneficiary to the principal . . . and not otherwise repaid."[196] All three types apply only "within the limits of a stated sum of money."[197]

By far the most detailed treatment has been given to procedures involving documentary compliance. Such attention is indicative of the importance of the documentary format as well as the types of difficulties which have developed in the experience of international bankers. The rules distinguish between two forms of guarantees: those in which operative documentation has been clearly specified,[198] and those in which "the guarantee does not specify the documentation to be produced in support of a claim."[199] Since the drafters of the ICC Rules

190. ICC RULES art. 1, *as amended,* ICC Document No. 460/168-470/244 (Aug. 5, 1974).

191. INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1962 rev.) (see note 23 *supra*).

192. ICC RULES art. 2.

193. The name of a fourth entity—the instructing party—also figures prominently in article 2 and appears to cover the case where one guarantor provides the guarantee through another; thus, the instructing party plays a role similar to that of a requesting bank on a traditional letter of credit. *See* discussion note 13 *supra.*

194. ICC RULES art. 2(a).

195. *Id.* art. 2(b). Interestingly, the rules permit parties to provide explicitly for payment by the guarantor at his option. *Id.* See *id.* art. 8, which specifies that the guarantor may exercise his performance option if he declares his intention to the beneficiary within the applicable period for payment. In this case, the analogy with the traditional credit becomes less persuasive.

196. *Id.* art. 2(c). This format might apply, for example, to the documented discount note. *See generally* Armstrong, *supra* note 7.

197. ICC RULES art. 2.

198. *Id.* art. 8.

199. *Id.* art. 8 bis, *as amended,* ICC Document No. 460/168-470/244 (Aug. 5, 1974). The rules as originally drafted distinguished between three sorts of payment terms: the two mentioned in the text, and a third, "payable on simple or first demand." ICC RULES art. 8 bis. This latter form, apparently requiring only a demand to trigger payment, was treated by the original article 8 bis as payable 7 days after the guarantor's receipt of a claim. Guarantees for which documentation was not specified were subject to a 30-day waiting period after which the guarantor was required to pay unless notified that the principal intended to invoke judicial or arbitral proceedings.

Amended article 8 bis no longer attempts to deal with guarantees payable on simple or first demand. It is confined to those for which documentation is not specified and

viewed the principal as fully protected in the former case,[200] article 8 provides for only a 7 working-day period between receipt of the claim and payment, giving the guarantor time to "satisfy himself that such claim and documentation appear on their face to comply with the requirements of the gurantee."[201]

The latter situation, where documentation is not specified, is covered in article 8 bis. In this situation, the rules impose a separate statutory compliance standard for each of the three types of guarantee. For example, a claim against a performance guarantee which does not specify required documentation must include "a statement of the beneficiary indicating specifically in what respect the principal has defaulted in due performance of the terms of the contract and confirming that on due demand in accordance with the terms of the contract the principal has not remedied such non-performance in kind or by payment."[202] If the beneficiary provides the required information, the guarantor must pay after 21 working days—or a longer period, if specified—have elapsed.[201] The beneficiary's claims of specific default, notice, and failure to cure are treated as equivalent to full documentary compliance.[204]

The ICC Rules demonstrate that the drafters viewed difficulties such as those presented in *Dynamics*, *Fair Pavilions*, and *Wichita Eagle* as the most serious obstacle to the continuing development of documentary security devices. The proposed rules provide strong support for the proposition, drawn from those cases, that compliance abuses can best be corrected by adopting minimal, yet definitive compliance standards.

The ICC Rules will naturally be compared with the UCP.[205] Although the two sets of rules are both expressly invoked by the parties and presumably have similar legal effect,[206] differences in their content

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provides for a 21-day waiting period so that the guarantor may determine whether the article's minimum compliance standards have been met.

Several members of the ICC Working Party, see discussion note 153 *supra*, objected to exclusion of guarantees payable on first demand from the scope of the rules "insofar as they represented a common practice which was precisely the one which led to the greatest abuses." By a vote of 5 to 4, however, first demand guarantees were excluded from the coverage of amended article 8 bis. ICC Document No. 460/168-470/244, *supra* at 3.

200. Comments by Professor Lars Hjerner on Revised Draft of Mar. 1, 1973, *supra* note 103, at 4.

201. ICC RULES art. 8.

202. *Id.* art. 8 bis(b).

203. *Id.* art. 8 bis.

204. *Id.*

205. *See* discussion note 23 *supra*.

206. The UCP has "valid and binding" effect unless there is some conflict between a UCP article and a mandatory provision of article 5 of the *Uniform Commercial Code*. J. WHITE & R. SUMMERS, *supra* note 9, at 611.

and approach betray diverse objectives and origin. The UCP developed against a backdrop of sophisticated letter of credit law and practice.[207] By contrast, the ICC Rules attempt to sever a particular sort of agreement, guarantees, from the body of letter of credit doctrine, in order to hasten the evolution of law and practice appropriate to that transaction's aims. The ICC Rules appear simple, even skeletal, compared to the UCP, but may become more detailed as specific techniques are discovered and incorporated into the rules.

One of the most intriguing aspects of the ICC Rules is their probable status under United States law. With one possible exception,[208] the proposed rules fall on the letter of credit side of the Comptroller of the Currency's regulation distinguishing letters of credit from ultra vires guaranties.[209] While the regulation does not completely dispose of the issue, it strongly implies that national banks possess the legal power to issue or confirm the proposed contract guarantees. It is also quite possible that the guarantees will be governed by article 5 of the *Uniform Commercial Code*,[210] although there may be certain minor conflicts between the ICC Rules and mandatory provisions of article 5.[211] In most respects, however, article 5 allows contracting parties wide latitude for agreement, and in these instances, the proposed rules would undoubtedly control.[212] In many cases, however, brevity of the rules undoubtedly would require their supplementation from both article 5 and decisional law.[213]

The ICC's proposed *Uniform Rules for Contract Guarantees* exemplify the emerging view among bankers that the guaranty transaction differs in substance and should be treated differently from the traditional letter of credit. Although this insight has not yet won full acceptance in the United States, it will aid courts in cases where traditional letter of credit law is inadequate to resolve problems posed by the use of guaranty credits.

207. *See generally* Funk, *supra* note 23.
208. The possible exception referred to is the Contract Guarantee authorized by article 2(b) of the ICC Rules. Under this sort of guarantee, the guarantor has the option "to arrange for performance of the contract." *See* text & note 195 *supra*. This type of guarantee may or may not run afoul of the ban on suretyship activity by banks. *See* text & notes 65-89 *supra*.
209. Comptroller of the Currency, Interpretive Ruling No. 7.7016, 12 C.F.R. § 7.7016 (1972) (reproduced in full at note 67 *supra*).
210. This conclusion is based on *Uniform Commercial Code* section 5-102. The proposed guarantees will almost certainly be issued by banks and require documentary drafts for payment. As section 5-103(b) and Comment 1 to section 5-102 indicate, a documentary draft may include a "notice of default." See note 19 *supra*. Thus the guarantees come within the terms of section 5-102(1)(a).
211. *See* discussion note 206 *supra*.
212. *See* discussion note 77 *supra*; *cf.* UNIFORM COMMERCIAL CODE §§ 1-102(3) to -(4), Comments 2-3 (establishing the Code's broad policy of freedom of contract).
213. *See* J. WHITE & R. SUMMERS, *supra* note 9, at 611.

CONCLUSION

The guaranty letter of credit has been called an "example of the commercial community pouring old wine into new flasks."[214] But, to extend the metaphor, the wine has not yet settled; although the guaranty credit's purpose requires a contractual device of the utmost reliability, guaranty credit practice is far from standardized and the instrument's legal status is still uncertain. Nonetheless, the benefits to be realized from refinement of the guaranty letter of credit are substantial. A fully trustworthy guaranty credit should reduce the cost of allocating commercial risk on a global scale. This goal can be achieved only if lawyers, bankers, and businessmen work diligently and ingeniously to solve problems in the transaction, most obviously those related to documentary compliance. Only if the transaction retains its documentary character will the guaranty credit be a significant advance—something more than a surety bond issued by a bank.

When guaranty credit arrangements break down due to unforeseen events or errors in drafting, courts must protect the intent of the parties by giving the crucial security transaction its intended effect. This means accepting the guaranty credit for the hybrid that it is and not frustrating its development by mechanical application of rules designed for either the traditional letter of credit or the surety bond. Because guaranty credits are still evolving, applicable law may not be wholly adequate to resolve problems they create. In such cases, courts should shape law to encourage effective use of guaranty credits, while respecting the basic principles responsible for the letter of credit's simplicity and certainty.

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214. Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 338 (N.D. Cal. 1971).