

Standby Letters of Credit and the Problem of Bad Faith Calls

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Introduction

The documentary letter of credit traditionally employed for transactions involving the sale of goods¹ has been joined since World War II by an apparently similar instrument called the “standby” letter of credit. The “standby” letter of credit differs fundamentally from the conventional or “sales” letter, because it resembles in function more a guarantee² than a sales letter of credit.³ For example, while payment under the sales letter of credit is virtually certain and is in fact intended, the standby letter theoretically provides for payment only if the customer⁴ defaults in his contractual obligations.

Many standby letters of credit, and particularly those involving a sovereign government as one party, allow the beneficiary to call for payment on the letter on the mere assertion that a default by the customer has occurred.⁵ Because considerable sums of money often are involved,⁶ such a call, if not based on an actual default by the customer, can result in serious inequities. Particularly if the customer is a relatively small economic agent, a “bad faith” call can unfairly result in

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1. The documentary letter of credit has been used for financing the sale of goods in international trade since the time of the Phoenicians. H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 3 (4th ed. 1958). See also Wiley, *How to Use Letters of Credit in Financing the Sale of Goods*, 20 *BUS. LAW.* 495 (1965). See generally I A. LOWENFELD, *INTERNATIONAL PRIVATE TRADE* 87 (1977).

2. See *infra* text accompanying notes 24-29.

3. See *infra* text accompanying notes 9-23.

4. The *customer* in both letters of credit ultimately provides the funds required by the letter; the *issuer* is the intermediating party, generally the bank, who pays the *beneficiary* upon this latter party's *call* on the letter, as provided by the transaction's contract between the customer and the beneficiary.

5. Such a requirement is very common in transactions between private contractors and public sector entities, particularly from non-Western countries. See White, *Bankers Guarantees and the Problem of Unfair Calling*, 11 *J. MAR. L. & COM.* 121, 124 (1979); *The Snag in Arab Contracts*, *BUS. WK.*, Apr. 25, 1977, at 85.

6. The standby letter of credit that American Bell provided the Imperial Republic of Iran was issued for more than \$38,000,000, on a contract worth more than \$280,000,000. See *American Bell Int'l Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420 (S.D.N.Y. 1979). Standby letters are usually issued for five to fifteen percentage points of the total contract price.

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the customer's bankruptcy.⁷ If a number of such calls are made on the same bank, the solvency of the bank can be threatened as well.⁸ The long-term effect of bad faith calls is greater uncertainty in international service or performance contracts, with higher prices and less trade.

Courts have struggled to develop a consistent and equitable framework for dealing with cases that involve bad faith calls. But, as this Article demonstrates, the resulting doctrine is confusing, uncertain, and frequently unfair. The Article seeks to provide the missing analytical framework. First, standby letters are distinguished from the conventional sales letters of credit. Such treatment recognizes both the different purposes each instrument serves as well as the different legal considerations involved in the underlying transactions. To avoid weakening the legal principles developed in the context of the traditional sales letter of credit, an approach based on the common law principle of replevin is adopted for dealing with standby letters. After examining some possible problems using this framework, the Article concludes that such an approach not only is legally feasible, but also best balances the international commercial policy goals of minimum risk for the beneficiary and maximum certainty for the customer.

I. Sales Letters, Guarantees, and Promissory Notes: A Comparison with Standby Letters of Credit

The unique nature of the standby letter of credit can best be demonstrated by an examination of three similar, but ultimately different, financial arrangements.

7. A *bad faith* call occurs when the *beneficiary* of a standby letter represents to the issuing bank that the *customer* has defaulted on his contractual obligations when no such default has occurred in fact. See *infra* text accompanying notes 37-38.

8. At least one American bank, the United States National Bank of San Diego, has failed as a result of overcommitments on standby letters of credit. See *First Empire Bank—New York v. Fed. Deposit Ins. Corp.*, 572 F.2d 1361 (9th Cir. 1978). For a discussion of the implications of this failure, including congressional action, see Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 TUL. L. REV. 314 (1979).

This failure occurred despite the fact that federal banking authorities have subjected standby letters to bank lending limits since 1974, pursuant to 12 C.F.R. §§ 7.1160, 208.8(d), 337.2 (1981). Note, "*Fraud in the Transaction*": *Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992, 1013 (1981).

The risks posed by standby letters to the banking system have occasioned an acrimonious academic debate. See Arnold & Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272 (1978); Justice, *Letters of Credit: Expectations and Frustrations* (pts. 1 & 2), 94 BANKING L.J. 424, 493 (1977); Harfield, *The Standby Letter of Credit Debate*, 94 BANKING L.J. 293 (1977); Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697 (1975); Naegele, *Unsound Banking Practices—A Paper Dealing with Standby Letters of Credit and Other Bank Guaranties*, in SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 1ST SESS., COMPENDIUM OF MAJOR ISSUES IN BANK REGULATION 647 (Comm. Print 1975).

A. *Sales Letters of Credit*

A seller wishing to trade with a distant buyer clearly will be concerned about his trustworthiness and ability to pay for the traded goods. The seller will want to minimize the time between shipping those goods and receiving payment for them. Finally, he will wish to avoid any contact with the buyer's legal system, a system with which the seller is unlikely to be familiar.

To deal with these concerns, the seller would ask the buyer to authorize a mutually trusted party, generally a bank,⁹ to pay out the agreed contract price in exchange for certain, pre-arranged documents.¹⁰ The bank's commitment to pay under this arrangement is the letter of credit, which it "opens" in favor of the seller. When the seller presents the bank, or "issuer," with the pre-arranged documents, he receives the amount owed to him for the shipped goods. The seller is therefore promptly paid, while the buyer is assured of documents that, at a minimum, establish title to the goods. This arrangement works so well that it is used for as much as ninety percent of American yearly merchandise imports.¹¹

Central to the reliability of the sales letter of credit is the apparently automatic or independent nature of the bank's commitment to the beneficiary under the letter of credit. The courts have conceived of this "independence principle" as involving three distinct contracts.¹² First, the customer and the beneficiary agree to exchange money for goods in the "underlying" or actual contract. Second, the customer pays a fee to the bank, and gives a commitment to pay the funds that are to be exchanged with the beneficiary. Finally, the beneficiary exchanges the documents, which are valuable and negotiable,¹³ with the bank for the

9. A number of generally unimportant variations as to the identity of the intermediating parties exist, such as the possible presence of two banks, one for each contracting party, where the two banks trust each other and the two other parties know or trust only their respective banks.

10. Customary documents in the sales letter of credit case include the draft or bill of exchange (enabling seller to draw on buyer's accounts with intermediating bank), a bill of lading, a commercial invoice, and generally an insurance policy. 1 A. LOWENFELD, *supra* note 1, at 87-88.

11. Note, *Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114*, 63 MINN. L. REV. 487 (1979).

12. See, e.g., *Venzelos, S.A. v. Chase Manhattan Bank*, 425 F.2d 461, 464-65 (2d Cir. 1970). The "independence principle" is standard to most academic discussions of the letter of credit. See, e.g., Justice, *supra* note 8, at 427-30; Note, *The Role of Standby Letters of Credit in International Commerce: Reflections After Iran*, 20 VA. J. INT'L L. 459 (1980).

13. See, e.g., *Lantz Int'l Corp. v. Industria Termotecnica Campana, S.P.A.*, 358 F. Supp. 510 (E.D. Pa. 1973); *Discount Records Ltd. v. Barclays Bank Ltd.* [1975] 1 All E.R. 1071; Justice, *supra* note 8, at 504 (discussing negotiability of documents under sales letter of credit).

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money specified by the letter of credit.

As these contracts are theoretically separate and independent, the issuing bank should be concerned only that the documents presented by the beneficiary comply with the terms under which the letter of credit is issued, not with the actual performance of the customer and beneficiary under the “underlying contract.”¹⁴ Commentators have argued that the issuer’s strict obligation to pay on the presentation of correct documents is critical to international trade.¹⁵

At first glance, the standby letter of credit may seem similar enough to the sales letter to justify identical legal treatment.¹⁶ As with the sales letter, a customer authorizes an issuer to pay a beneficiary a specified amount on the beneficiary’s delivery of prearranged documents. Closer inspection, however, quickly reveals fundamental differences.

The standby letter is issued by the seller instead of the buyer. The typical “commodity” sold is a service contract, such as a construction project, instead of any tangible “good.” The customer/seller provides the standby letter as a guarantee to the beneficiary/buyer that his performance will comply with the underlying contract. The standby letter is thus issued with the expectation that it will not be called.¹⁷

14. *See, e.g.*, *O’Meara Co. v. Nat’l Park Bank*, 239 N.Y. 386, 146 N.E. 636 (1925) (bank obligated only to verify that documents presented strictly comply with terms of underlying letter of credit); *R.D. Harbottle Mercantile Ltd. v. Nat’l Westminster Bank Ltd.*, [1977] 2 All E.R. 862, 870 (same). For the extent of formality in the bank’s verification of the documents to which this independence principle can lead, see *Courtaulds North America, Inc. v. N.C. Nat’l Bank*, 528 F.2d 802, 805 (4th Cir. 1975); *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 336 A.2d 316, 323 (1975).

For a contrary view, see Comment, *The Effects of Issuing Bank Insolvency on Letters of Credit*, 21 HARV. J. INT’L L. 161, 177-78 (1980), which discusses the conditional payment theory adopted in the U.C.C. § 2-235(2). This theory maintains that the seller has a cause of action against the unsatisfied portion of the purchase price should the issuing bank fail. As such, this argument indicates that the letter of credit is only a conditional, possibly partial, payment of the customer’s obligation to the beneficiary and is therefore necessarily related to the overall contract.

Courts have suspended the doctrine of independence in exceptional cases where fraud appears, where the issuer is given appropriate notice of such fraud, and where no holder in due course of any of the negotiable documents is involved. *See generally* Justice, *supra* note 8, at 503-04. The exception was formulated by a New York Supreme Court, in New York County, in *Sztejn v. J. Henry Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (1941) (injunction of sales letter of credit issued on summary judgment under circumstances indicating intentional fraud by seller/beneficiary, where merchandise shipped “not merely inferior in quality . . . but worthless rubbish,” 31 N.Y.S.2d at 635). The doctrine in *Sztejn* has been labelled the “fraud in the transaction” exception.

15. Justice, *supra* note 8, at 505, cites Lord Mansfield’s words to this effect in *Pillans v. Van Mierop*, 3 Burrow 1663, 1669 (1765).

16. Most commentators believe standby letters of credit are governed by the same commercial principles as sales letters of credit, although many recognize at the same time that the standby letter is the “psychological opposite” of the sales letter. *See, e.g.*, Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C. L.J. 251, 258 (1971).

17. Arnold & Bransilver, *supra* note 8, at 279.

The beneficiary generally calls on the letter by presenting the issuer a written and personally signed assertion to the effect that the customer has defaulted under the contract.¹⁸ As such, the bank receives a "document" that does not represent any specific good, is not negotiable, and is therefore of no value to the bank.¹⁹

The worthless nature of the document the beneficiary presents to the issuer suggests perhaps the most important legal distinction between the sales and standby letters of credit. The independence principle, the basis for the sales letter of credit,²⁰ requires the existence of three separate contracts. In the standby context, however, the beneficiary does not supply the issuer with any consideration. Therefore no contract arises between the beneficiary and the issuer, and the three-contract paradigm collapses.²¹ In the standby context, because no contract exists between the beneficiary and the issuer, the arrangement between the customer and the issuer resembles more closely that of principal and agent. In a sense, the customer hires the issuer for a fee and authorizes him to perform a specific task.²²

The three-contract paradigm is therefore inapplicable to the standby letter of credit. This insight presents a danger. Once the paradigm is found inapplicable, the doctrine of strict independence supported by the paradigm should be found inapplicable as well. It could plausibly be argued that courts should "pierce" the standby "independence" to examine the factual circumstances involved whenever a bad faith call is alleged. This response, if not properly limited, could undermine both the sales letter of credit and the standby letter.

Such a response would threaten the central policy behind the standby instrument: maximizing the certainty to the beneficiary that the customer will perform the contract. Were the courts to examine, upon the customer's mere allegation of breach by the beneficiary, the

18. Provisions permitting calls with this minimal requirement of documentation have been called "suicide" or unconditional letters of credit. Comment, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. J. INT'L L. 189, 196 (1980). See also *supra* note 5.

19. Jarvis, *Standby Letters of Credit—Issuers' Subrogation and Assignment Rights* (pt. 1), 9 U.C.C. L.J. 356, 369 (1976). Cf. *supra* text accompanying note 13.

20. See *supra* text accompanying notes 12-15.

21. This argument refutes the view of most commentators that the independence principle, and the consequent three-contract paradigm, extends to the standby letter. See, e.g., Harfield, *supra* note 16, at 258; Note, *supra* note 12, at 460.

22. Given the requirement of strict compliance of the presented documents, see *supra* note 14, the scope for independent action by the bank would seem very small, confirming the character of such action as that of an agent. This character is much more evident in the standby context than in the traditional sales context, as the latter arrangement yields the issuing bank documents of at least some independent value.

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frequently complex issues involved in assessing whether such a breach had in fact occurred, the customer could initiate litigation in his own jurisdiction whenever the beneficiary might call on the instrument. As the customer has nothing to lose in initiating such suits beyond what are likely to be relatively less expensive legal costs for him,²³ such initiative might be subject to abuse. To prevent such abuse, procedural safeguards should be established that would balance both the interests of the customer in combatting bad faith calls and of the beneficiary seeking to minimize foreign litigation.

B. *Guarantees*

If the standby letter resembles the sales letter of credit formally, it resembles the guarantee more closely in substance. Like the standby letter, the guarantee is a contingent commitment, designed to ensure adequate performance by the seller-contractor. This function is so similar to the standby letter that the standby letter is often referred to as a guarantee letter of credit²⁴ or a "banker's guarantee."²⁵ A number of important formal differences do, however, exist.

The chief formal difference between the standby letter and the guarantee is that the latter is *not* legally independent of the underlying transaction, but is "ancillary" to it.²⁶ That is, the guarantor pays when he has verified that the primary obligor has defaulted. This requirement of verification can result in lengthy trials, investigations, or arbitrations, and is thus objectionable to beneficiaries who desire a maximum of certainty and a minimum of foreign judicial wrangling. This problem does not often arise with the standby instrument, because the courts ascribe to it the independence principle borrowed from the sales letter context.

23. As the customer would file the motion to enjoin payment in his own jurisdiction, he is more likely to be familiar with the legal system than would the beneficiary, and would probably have the benefit of trusted legal advice. Even if the beneficiary has able counsel on retainer in that jurisdiction, the expense of responding to a long list of complaints in a foreign jurisdiction is likely to be greater, and is certainly less attractive, if a provision allowing for unconditional call under the standby letter had been negotiated. If the customer loses or drops the suit, he loses only what he would have lost anyway, i.e., the amount owed under the standby letter.

24. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716 (1973). As guarantees are *ultra vires* for banks in the United States, Verkuil notes that it is hardly surprising that the term "standby" letters of credit is more popular than "guaranty letters." Verkuil, *supra* note 8, at 314 n.1.

25. The British call the standby letter a "banker's guarantee," while referring to the American guarantee as a "performance bond." See White, *supra* note 5, at 124. English courts have observed that banker's guarantees are "in effect . . . performance bonds." R.D. Harbottle Mercantile Ltd. v. Nat'l Westminster Bank Ltd., [1977] 2 All E.R. 862, 864.

26. H. HARFIELD, BANK CREDITS AND ACCEPTANCES 163-64 (5th ed. 1974).

Consistent with their legal concern about the underlying circumstances, guarantors usually undertake a more thorough credit check before they issue the surety bond than do issuers of standby letters. As a partial consequence, standby letter fees are cheaper.²⁷

Finally, United States banks may not legally guarantee the debts of third parties. Such action is *ultra vires*.²⁸ This difference is highly formal, and is maintained by the courts principally to avoid finding that the standby instrument is a guarantee. A finding to that effect would otherwise permit the defense of *ultra vires* to excuse a bank/issuer from reneging on its commitment to a beneficiary.²⁹

C. *Promissory Notes and Standby Letters of Credit*

Perhaps the clearest statement of the legal profession's difficulties in

27. *Id.* at 178; banks generally issue standby credits at a price of one per cent of face value or less while surety (performance) bonds cost upwards of two per cent. Letter from Professor Dan Murray to Senator William Proxmire (June 6, 1976), reprinted in REGULATION OF STANDBY LETTERS OF CREDIT: HEARINGS ON S. 2347 BEFORE THE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94th Cong., 2d Sess. 147-48 (1976) [hereinafter cited as HEARINGS]. See also Note, *supra* note 8, at 1001 (attributing inexpensiveness of standby letter to fact that issuing bank "merely processes documents" pursuant to independence principle).

28. See, e.g., *Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73, 77 (5th Cir. 1922); *Prudential Ins. Co. v. Marquette Nat'l Bank*, 419 F. Supp. 734, 735 (D. Minn. 1976); 12 U.S.C. § 24 (1981); Note, *Recent Extensions in the Use of Commercial Letters of Credit*, 66 YALE L.J. 902, 911-16 (1957). Jarvis suggests that "the main reason why banks issue standby letters of credit is to get around *ultra vires* problems." Jarvis, *Standby Letters of Credit* (pt. 2), 10 U.C.C. L.J. 38, 45 n.21 (1977).

The rule against guarantees flows from federal concern over the solvency of the banks. See generally Verkuil, *supra* notes 8 and 24. Given the demand for standby letters, and the desire of many large banks to provide the lucrative guarantee function to their clients, the effect such rule has today is questionable. See *infra* note 29.

29. While the weight of modern criticism and most judicial opinion seems to be that the defense of *ultra vires* is ineffective, enough controversy remains to ensure continued litigation. The defense has been successfully used in *Citizens' Nat'l Bank v. Appleton*, 216 U.S. 196 (1910); *Rothschild v. Manufacturers Trust Co.*, 279 N.Y. 355, 18 N.E.2d 527 (1939); more important, Verkuil has argued that it played a role in the settlement of *Burton v. Mercantile Nat'l Bank*, Civ. No. 14839 (N.D. Ga. 1971) (settled). Verkuil, *supra* note 24, at 724-27. The defense has been unsuccessfully used in, e.g., *Wichita Eagle & Beacon Publ'g Co. v. Pacific Nat'l Bank*, 493 F.2d 1285 (9th Cir. 1974) (court held what was formally called standby "letter of credit" was guarantee, but enforced it to prevent bank from pleading *ultra vires* defense against its commitment to pay); *Barclays Bank N.C.O. v. Mercantile Nat'l Bank*, 339 F. Supp. 457 (N.D. Ga. 1972), *aff'd*, 481 F.2d 1224 (5th Cir. 1973) (defendant unsuccessfully argued that its letter of credit was a guarantee and therefore *ultra vires*); *Fed. Deposit Ins. Corp. v. Freudenfeld*, 492 F. Supp. 763, 768 (E.D. Wis. 1980) (in bankruptcy, issuer of standby letter of credit not allowed to challenge it as a guarantee and therefore *ultra vires*, but United States would have standing to do so). But see *Awotin v. Atlas Exchange Nat'l Bank*, 295 U.S. 209 (1935) (bank not estopped from raising *ultra vires* defense by fact that one of its officers effected the act in question). See also Harfield, *supra* note 8, at 296; Justice, *supra* note 8, at 430.

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trying to classify standby letters of credit was written by Lord Denning in *Owen v. Barclays Bank*:

[A]s one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. So long as the . . . customers make an honest demand, the banks are bound to pay: and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay.³⁰

While standby letters may resemble promissory notes, in effect constituting instruments payable on demand, one can scarcely maintain that they were issued in order to settle an existing debt, or even that they were intended or expected to settle a debt at all. Moreover, standby letters are not negotiable.³¹ Rather, this analogy serves to illustrate the confusion that results from adapting existing legal theories to fit a new and unique financial instrument.

II. The Role of the Standby Letter of Credit

The various factors distinguishing the standby letter from the three financial instruments examined above, together with the widespread use of the standby letter,³² indicate that this instrument fulfills a unique role in international commerce. While the standby letter has proved attractive to American banks principally as a means for circumventing ultra vires problems, the features of reliable, mechanical payment, relatively inexpensive banker's fees, and the promise of minimal litigation have appealed to distrustful public sector bodies of developing nations.³³ The rapid growth in multinational construction projects has been due at least in part to the provision of this particular financial instrument.³⁴

Given the desire by many sovereign buyers to avoid litigation and to maximize control over Western contractors, it is hardly surprising that many of these standby arrangements have had unconditional or "suicide" calling provisions.³⁵ Such provisions, in turn, have facilitated a

30. [1978] 1 Lloyd's L.R. 166, 171.

31. See *supra* note 13. See also White, *supra* note 5, at 125.

32. On December 31, 1975, \$11.7 billion in standby letters of credit were outstanding. Three years later, the amount outstanding for just Citicorp, Chase Manhattan Corp., Manufacturers Hanover Trust Corp., Chemical New York Corp., and Bankers Trust Corp. was \$12.6 billion. Note, *supra* note 12, at 467.

33. See White, *supra* note 5, at 124. Businessmen reported that Arab suspicion of United States courts was very strong, even before the Carter Administration froze Iranian assets in 1979. See *The Snag in Arab Contracts*, Bus. Wk., Apr. 25, 1977, at 85.

34. *The Snag in Arab Contracts*, Bus. Wk., Apr. 25, 1977, at 85.

35. See *supra* note 18.

number of bad faith calls, with the attendant inequities and potentially threatening implications for future progress in international commerce.³⁶

III. The Problem of Bad Faith Calls

After briefly discussing the potential effects of a bad faith call on a standby letter of credit, this Article examines a number of cases involving such calls. The analysis of these cases which concludes this section stresses the need for a distinct legal treatment of the standby instrument.

A. *The Effects*

When a major beneficiary exercises its "unconditional" right to call for payment of the standby letter, it may cause the bankruptcy of the customer and severe solvency problems for the bank.³⁷ If the call is, or is perceived to be, unwarranted, such results furthermore damage the confidence and trust of other, potential traders. The risk of such a bad faith call may be expected to have a serious impact on the relatively smaller contractors, for whom the standby letter may constitute a dangerous possibility of bankruptcy. Contract prices will almost certainly increase to take such risk into account.³⁸ With higher prices and fewer small participants, it is likely that fewer contracts will be concluded and that international commerce will decline as a consequence.

The law should be shaped to lessen such uncertainty in international transactions³⁹ by curbing instances of gross inequity through judicial examination of the factual predicate of allegedly bad faith calls. The existence of such ultimate examination would encourage both parties to deal in good faith. At the same time, the basic role of the standby

36. See *infra* text accompanying notes 37-38.

37. The amounts involved in standby letters are generally substantial percentages of the underlying contract. See *supra* note 8. Some courts have specifically made exceptions to their strict enforcement of (standby) letters of credit if such enforcement would result in bankruptcy. See *Sperry Int'l Trade, Inc. v. Israel*, No. 81-7751, slip op. at 904 (2d Cir. Jan. 21, 1982); *NMC Enterprises, Inc. v. Columbia Broadcasting Sys.*, 14 U.C.C. Rep. Serv. (Callaghan) 1427 (Sup. Ct. N.Y. Co. 1974). See also note 58 *infra*, discussing bankruptcy as an underlying factor in the decision in *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*, 356 F. Supp. 991 (N.D. Ga. 1973).

38. See *Jarvis*, *supra* note 19, at 358-59.

39. See, e.g., *Alfred Dunhill of London, Inc. v. Cuba*, 425 U.S. 682, 702 (1976) (enormous increase in extent of foreign sovereign involvement "in international trade made essential 'a practice which will enable persons doing business with them to have their rights determined in the courts'"). See also Comment, *supra* note 18, at 243 (discussing need for confirming trading entities' expectations, thereby fostering trust and certainty required for international trade).

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instrument should be preserved. As the following examination of a number of bad faith cases will demonstrate, the courts have thus far been unsuccessful in achieving this balance.

B. *The Cases*

By far the greatest number of “bad faith call” cases have resulted from the circumstances surrounding the Iranian revolution of 1979. With the change to an Islamic fundamentalist government, at least twenty-three contractors involved in sophisticated construction projects in Iran sued to enjoin their American banks from honoring anticipated Iranian calls.⁴⁰ Though some “notice” injunctions were granted, requests for permanent injunctions were in every case denied.⁴¹ These “notice” injunctions were issued to enable the customer to determine if the “fraud in the transaction” exception, developed in the sales letter context, could be satisfied in these standby cases.⁴² Given the enormously difficult task of collecting information out of Iran and the uncertain meaning of “fraud in the transaction,”⁴³ it was perhaps to be

40. Note, *supra* note 8, at 994.

41. See generally Comment, *supra* note 18, at 215-21.

42. See *supra* note 14. For cases granting these notification periods, see *Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (S.D.N.Y. 1979); *Harris Int'l Telecommunications v. Bank Melli Iran*, No. 79 Civ. 802 (S.D.N.Y. Feb. 22, 1979). Such temporary injunctions were granted in recognition that “[p]laintiff's sole remedy would be to institute an action in the courts of Iran, which in light of the present situation would make any relief questionable.” 467 F. Supp. at 533. Even such temporary injunctions have been denied in the majority of cases where irreparable injury was held to be lacking and where present fraud was not effectively alleged. See, e.g., *Sperry Int'l Trade, Inc. v. Israel*, No. 81-7751, slip op. at 904 (2d Cir. Jan. 21, 1982); *KMW Int'l v. Chase Manhattan Bank, N.A.*, 606 F.2d 10, 14-15 (2d Cir. 1979).

43. Plaintiffs seeking to enjoin payment under any letter of credit had to make a showing of (a) irreparable harm; and (b) either (1) a likelihood of succeeding on the merits, or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a “balance of hardships tipping decidedly toward the party requesting the preliminary relief.” *Jackson Dairy, Inc. v. H.P. Hood & Sons, Inc.*, 596 F.2d 70, 72 (2d Cir. 1979) (per curiam).

Although some courts have denied such relief solely on the finding that no irreparable harm existed, see, e.g., *Sperry Int'l Trade, Inc. v. Israel*, No. 81-7751, slip op. at 902-03 (2d Cir. Jan. 21, 1982), most courts examined the question of whether “fraud in the transaction” occurred under the second or third prong of this test. Standards for this exception have varied widely. Compare *NMC Enterprises, Inc. v. Columbia Broadcasting Sys.*, 14 U.C.C. Rep. Serv. (Callaghan) 1427, 1429 (Sup. Ct. N.Y. Co. 1974) (“where the documents or the underlying transaction are [sic] tainted with intentional fraud”) with *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*, 356 F. Supp. 991, 998 (N.D. Ga. 1973), quoting *Sec. & Exch. Comm'n v. Capital Gains Bureau*, 375 U.S. 180, 193 (1963), quoting *DEFUNIAK, HANDBOOK OF MODERN EQUITY* 235 (2d ed. 1956) (“intention to defraud or misrepresent is not a necessary element”). Perhaps more realistically, see *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 41 N.Y.2d 254, 260-61, 360 N.E.2d 943, 949, 392 N.Y.S.2d 265, 271 (1976), which applied a “flexible standard” for fraud in the transaction, “to be applied as the circumstances of a particular situation mandate. It can be difficult to draw a precise line between cases involving breach of warranty (or a difference of opinion as to the quality of goods) and outright fraudulent practices on the part of the seller” (footnote

expected that no permanent injunctions were granted.

A case accurately describing the difficulties of establishing "fraud in the transaction" while illustrating some of the inequities implicit in the bad faith call is *United Technologies Corp. v. Citibank, N.A.*⁴⁴ There, the plaintiff had agreed to sell telephone cables valued at \$20 million to Iran and was required to procure performance bonds approximately equal to 10% of the contract price.⁴⁵ The plaintiff requested that Citibank issue two irrevocable standby letters of credit in favor of the Iranian bank and proceeded to perform the underlying contract. The uncontradicted evidence before the court indicated that both sides had completed the contract by August of 1978, although the letters of credit had previously been extended through January and February of 1979. On December 23, 1978, the Iranians sought to extend the January letter. At the request of United Technologies, Citibank replied that the letters should be cancelled as performance was complete. Before the issue was resolved,⁴⁶ the January deadline had passed. On February 27, Iran requested payment on the letters, without addressing the issue of completed performance. The court in turn rejected United Technologies' subsequent motion to enjoin payment. Rather, the court held that United had failed to show "active fraud"⁴⁷ and required that Citibank honor the letter of credit in conformance with the independence principle.⁴⁸

The court in *United* rigidly applied sales letter of credit doctrine, and in particular the independence principle. It noted, however, that the letter of credit used by United Technologies was "unlike the usual pattern" in that it was issued "as a guarantee of its [United Technologies'] contractual performance."⁴⁹ Though the plaintiff alleged, without con-

omitted). The first two cases cited involved standby letters, while the last case was concerned with a sales letter of credit.

44. 469 F. Supp. 473 (S.D.N.Y. 1979).

45. *Id.* at 475. One of the letters of credit had been reduced to \$1,128,245 from \$1,861,245 in May of 1977, indicating the length of time over which the contract was to be performed. At that time, the stability of the Iranian government was unquestioned, warranting the expectation that all sides would continue to cooperate under the contract.

46. The court held that the civil unrest in Iran interfered with the communications needed to resolve this dispute. *Id.*

47. *Id.* at 478.

48. *Id.* at 477, 480. The court also used language to the effect that the customer in the letter of credit contract assumes the risk of political disruption of normal commercial practice. Why such risk is not assumed by the contractee of the underlying contract instead was not made clear. Nor did the court distinguish between the "political turmoil" involved and the bad faith nature of a call made after completion of the underlying contract. *Id.* at 479. For a discussion of the possibilities of using a "politically motivated" bad faith call test for injunction, see *infra* note 91.

49. 469 F. Supp. at 477.

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tradition, that it had completed performance, the court held that it did not meet the standard of proof demanded by “fraud in the transaction.”

Relief was similarly denied to plaintiffs who had not begun to perform on the underlying contract, and who had not even received the down payment from the Iranians that was to initiate the plaintiff's duty to perform.⁵⁰ Because the plaintiffs were under no duty to perform anything until such down payment was received, it is difficult to imagine how the Iranians could have made a good faith call. Nevertheless, the court held that it would grant relief only in case of a “‘clear showing of the active intentional fraud complained of.’”⁵¹

Cases prior to the Iranian litigation interpreted the “fraud in the transaction” standard more liberally. In two standby letter cases arising after the Cuban revolution,⁵² New York state courts held that a call on the standby letter constituted “fraud in the transaction” where “it is demonstrated that the borrower and the Bank for whose benefit the letter of credit was issued have colluded to prevent the liquidation of the debt.”⁵³ That fraud in the transaction occurred where the government calling on the standby letter intervened, preventing the customer's performance of his duties on the underlying contract.

Perhaps the best known decision holding for a customer seeking to enjoin payment under a standby letter of credit is *Dynamics Corp. of America v. Citizens & Southern National Bank*.⁵⁴ There, the plaintiff had requested an American bank to issue a standby letter of credit in favor of India, which letter India could call on merely by asserting that the plaintiff had defaulted.⁵⁵ In 1971, in response to the war between India and Pakistan over what was to become Bangladesh, President Nixon placed an embargo on military supplies to India. These supplies

50. *KMW Int'l v. Chase Manhattan Bank, N.A.*, 606 F.2d 10 (2d Cir. 1979).

51. *Id.* at 16, citing *American Bell Int'l v. Manufacturers Hanover Trust Co.*, No. 3157/79, slip op. at 8, 10 (N.Y. Sup. Ct. Mar. 26, 1979), *aff'd* N.Y.L.J., June 28, 1979, at 6, col. 1 (N.Y. App. Div.). Although no call had yet been made in the *KMW* case, when a call was made in a virtually identical case, the court refused to grant relief, relying heavily on the independence principle. *Balfour, MacLaine Int'l Ltd. v. Manufacturers Hanover Trust Co.*, N.Y.L.J., Jan. 25, 1979, at 11, col. 3 (N.Y. Sup. Ct. Jan. 19, 1979).

52. *St. Paul Fire & Marine Ins. Co. v. Bankers Trust Co.*, N.Y.L.J., Nov. 18, 1960, at 14, col. 1 (N.Y. Sup. Ct.); *Schering Corp. (Panama) S.A. v. Bankers Trust Co.*, N.Y.L.J., Sept. 30, 1960, at 14, col. 2 (N.Y. Sup. Ct.). The court in *Schering* held that the alien contractors never assumed the risk that the sovereign would alter its laws or judicial process, thereby preventing them from seeking the remedy which the parties had expected to utilize to counter an arbitrary demand. *Cf. United Technologies*, 469 F. Supp. 473, discussed *supra* at text accompanying notes 44-48. See generally Comment, *supra* note 18, at 240-41.

53. *Schering*, N.Y.L.J., Sept. 30, 1960.

54. 356 F. Supp. 991 (N.D. Ga. 1973).

55. *Id.* at 994, n.2.

included those manufactured by Dynamics. Plaintiff alleged that its duties on the underlying contract were to supply these goods F.O.B. at its plant, and that it was India's responsibility to ship the equipment from there to India.⁵⁶ After discussing the doctrine of "fraud in the transaction" at length, the court applied the standard for fraud set out in *Sec. & Exch. Com'n v. Capital Gains Research Bureau*: "[f]raud . . . properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another."⁵⁷ While somewhat confusingly asserting that the court could not and should not determine the "ultimate truth or falsity" of the questions brought before it,⁵⁸ the court did grant plaintiff a preliminary injunction. In doing so, the court shifted to India the burden of proving that the injunction should be lifted:

Since . . . this court has no business making an ultimate adjudication regarding compliance with the provisions of the underlying sales Agreement, India will not be required to *prove* that DCA [Dynamics] 'failed to carry out certain obligations of theirs' under the Agreement in order to get payment from the Bank. Rather, the court views its task in this case as merely guaranteeing that India not be allowed to take unconscientious advantage of the situation and run off with plaintiff's money on a *pro forma* declaration which has absolutely no basis in fact. If it should turn out that there is a legal and factual basis for India's certification, the court will leave plaintiff to its remedy at law.⁵⁹

The court in *Dynamics* thus shifted to the beneficiary the burden of proving that the customer had defaulted, after the customer had alleged full compliance with its duties. Although cited by the courts deciding the Iranian cases,⁶⁰ none adopted its approach to the burden of proving "fraud in the transaction."⁶¹

56. *Id.* at 996.

57. 375 U.S. 180, 194 (1963).

58. 356 F. Supp. at 999. The court did, however, state that a court could and should determine such questions in a situation like *Sztejn v. J. Henry Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (1941) (sales letter of credit case; *see supra* note 14).

59. 356 F. Supp. at 999 (emphasis in original). Dynamics Corporation had filed a petition in bankruptcy before the case was heard. *Id.* at 1000. The court recognized that Dynamics "would be severely disadvantaged" if the standby letter was paid. Given this fact, the court may have been especially receptive to Dynamic's allegations. *See also supra* note 37 (discussing special status possessed in injunction proceedings by plaintiffs facing bankruptcy).

60. *See, e.g., United Technologies*, 469 F. Supp. at 477, discussed *supra* at text accompanying notes 44-48. *Dynamics* appears to be cited principally for its dictum that a standby letter of credit is not the "usual pattern" for letter of credit arrangements.

61. For a recent, interesting case in which the court first ordered a *Dynamics* style temporary injunction which it ended 18 months later, with the "benefit of a spate of jurisprudence . . . generated by the recent turmoil in Iran," *see Cappaert Enterprises v. Citizens &*

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More recently, the problem of a bad faith call on a standby letter was raised in *Sperry International Trade, Inc. v. Israel*.⁶² There, Sperry sought to enjoin payment under a standby letter after alleging that the Israeli government had obstructed Sperry's efforts to perform. In granting this injunction, the District court focused on Sperry's good faith efforts.

The foregoing stay . . . is based on an ample showing of good faith prima facie on the part of Sperry and without prejudice to the ultimate determination of that question, as well as on a probability of [S]perry's success on the merits and possibility of irreparable harm were not such a stay of [f] certification granted, or as a minimum, on a balancing of hardships tipping decidedly toward Sperry and sufficiently serious questions going to the merits to make them a fair ground for litigation [arbitration].⁶³

The Court of Appeals reversed, applying a strict standard for the showing by Sperry of irreparable harm.⁶⁴ Shortly after Israel called on the standby letter, but within the period during which the issuing bank examined the documents presented,⁶⁵ Sperry successfully attached Israel's accounts with that bank.⁶⁶ Before the District Court could overturn the state court's attachment,⁶⁷ and pursuant to an arbitration clause in the contract, Sperry successfully won an award from the Arbitration Tribunal established under the contract requiring both parties to place the proceeds under the standby letter in a joint escrow ac-

Southern Int'l Bank of New Orleans, 486 F. Supp. 819, 826 (E.D. La. 1980). Note, however, that the case is complicated by actions taken by plaintiff's Kuwaiti co-venturer; the court, citing *KMW*, held the actions were controlled by the contractual terms agreed to by Cappaert. *Id.* at 828.

62. No. 81-7751 (2d Cir. Jan. 21, 1982) (reversing District Court's grant of preliminary injunction).

63. *Id.* Slip op. at 901-02. In focusing on the plaintiff's good faith efforts, rather than on the actions of the distant sovereign beneficiary, the District Court is shifting the burden of proof onto that beneficiary in a manner similar to the *Dynamics* court, *see supra* text accompanying note 58. Such focus is also adopted by the approach developed in this Article, *see infra* text accompanying note 99.

64. Slip op. at 904. The *Sperry* court seemed to recognize only a resulting bankruptcy as constituting "irreparable harm." The \$15 million payment involved in that case equalled the parent corporation's first quarter (1981) profits. Even though such a payment was alleged to affect Sperry's stock value drastically, slip op. at 905, the court did not accept such damage as constituting irreparable harm, regardless of how wrongfully it was caused.

65. When the beneficiary presents documents to call on a letter of credit, banks customarily demand three business days to examine the documents in order to verify compliance with the letter's terms. *See supra* note 14. This period is taken even, as here, where the beneficiary need only assert that the customer has defaulted.

66. *Sperry Int'l Trade, Inc. v. Israel*, 81 Civ. 5670, slip op. at 4-5 (S.D.N.Y. Feb. 24, 1982) (discussing procedural history of Sperry's successful attachment by New York state court judgment, Jan. 31, 1982; issuing bank subsequently certified to Israel, Feb. 2, 1982, that documents with respect to standby letter were in order).

67. *Sperry Int'l Trade, Inc. v. Israel*, 82 Civ. 641, Memorandum and Order (S.D.N.Y. Feb. 10, 1982).

count.⁶⁸ Thus, albeit in an expensive and circuitous fashion, Sperry effectively enjoined payment under the instrument. Whether such adroit manipulation of federal and state courts corresponds with the policy behind the standby letter is at least questionable.⁶⁹

C. *Implications of the Cases*

As this review of some of the most important litigation seeking to avoid payment under standby letters of credit indicates, the courts have concentrated on the sales letter of credit exception of "fraud in the transaction." The standard for this exception is not clearly defined, with the courts variously requiring plaintiffs to *prove* "active intentional fraud"⁷⁰ or merely to *allege* that the defendant has taken "undue and conscientious advantage" of the plaintiff.⁷¹ Where the plaintiff has sought to enjoin payment, the courts have applied the test for relief with similarly varying degrees of strictness.

Both in the standard of proof required for proving "active fraud in the transaction" and "irreparable harm" for the injunction, the courts have generally placed a heavy burden on plaintiffs. This burden is particularly onerous when the calling party is a major public entity and unresponsive to the discovery process. Without access to facts that might establish "active fraud," plaintiffs have been unsuccessful in their efforts to enjoin payment on the standby letters of credit they caused to be issued.

A frequently used policy ground for such strict standards against the customer in standby letter cases is the assertion that American foreign commerce, or more specifically the international reputation of American banks,⁷² is likely to be adversely affected if courts tamper with the "independence principle" underlying letter of credit law.⁷³ Besides failing to distinguish between standby and sales letters, however, this

68. The arbitrators handed down the award on February 9, 1982, one day before Judge Cannella vacated the state court attachment. 81 Civ. 5670, slip op. at 4-5.

69. The proceeds are in escrow, as a certificate of deposit, until the completion of arbitration. Since that arbitration is expected to last at least two years, the goal of efficiency and minimum court involvement under the standby arrangement clearly seems to be frustrated here. See *supra* text accompanying notes 23-24.

70. See *supra* note 58.

71. 356 F. Supp. 991, 999, *citing* Sec. & Exch. Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

72. See, e.g., KMW Int'l v. Chase Manhattan Bank, 606 F.2d 10, 17 (2d Cir. 1979) ("Chase's commercial honor is essentially at stake . . . and perhaps even American credibility in foreign communities"); Am. Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420, 426 (same sentiment on behalf of Manufacturers Hanover Trust).

73. See, e.g., KMW Int'l v. Chase Manhattan Bank, 606 F.2d 10, 15 (2d Cir. 1979) ("bank's obligation . . . totally independent of the underlying transaction").

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assertion ignores the adverse impact an overly formal and inequitable application of this principle has⁷⁴ on American foreign commerce and on American banks.

Despite the relatively uniform and strict enforcement by the courts of the independence principle,⁷⁵ the large number of cases challenging payment under standby letters indicates a practical rejection of that legal posture. Furthermore, the continuing challenges under the “fraud in the transaction” exception resulting from future bad faith calls on standby letters may expand this exception in such a way as to threaten the mechanical nature of payment inherently vital to the *sales* letter of credit.⁷⁶ For example, in its discussion of “fraud in the transaction,” the *Dynamics* court implied that it was a “relatively simple problem” for a court to determine whether a seller of goods has committed fraud.⁷⁷ The *Dynamics* court also cited with approval *Merchants Corp. v. Chase Manhattan Bank*.⁷⁸ In that case (involving a traditional *sales* letter of credit), the court found that “fraud in the transaction” occurred when a ship, that was required by terms of the underlying contract to be loaded with the purchased goods by January 31, 1968, was discovered still in the harbor of departure and being loaded with un-

74. See, e.g., *Corporacion de Mercadeo Agricola v. Mellon Bank Int'l*, 608 F.2d 43, 50 (2d Cir. 1979) (Gurfein, J., dissenting). There, the defendant refused to pay under a standby letter of credit even though a default had occurred. The bank successfully defended its action with the argument that the plaintiff/beneficiary's signing agent, who had been granted power of attorney by plaintiffs with respect to contractual and other matters, was not competent to sign the required documents claiming default. Judge Gurfein accused the bank of perpetrating a hoax and argued that formal compliance with the independence principle, far from enhancing or protecting the international reputation of American banks and commerce, had the opposite effect: “If a foreign business cannot rely on a bank guaranty through a ‘letter of credit’ when, though default has occurred, it is denied recovery without trial in American courts, the American image is tarnished.” *Id.* at 54. See also *supra* text accompanying notes 37-39.

75. See *supra* text accompanying notes 40-43. See also Counsel's Corner, *Sztejning the Letter of Credit: More Strings for the Bow*, 93 BANKING L.J. 954 (1976) (expressing concern at continuing efforts to enjoin payment under letters of credit, but also satisfaction at court's strict maintenance of independence principle; this Comment was written before the Iranian cases); Note, *supra* note 12, at 503 (interpreting uniform denial of permanent injunctions in Iranian litigation as indication of courts' willingness to maintain the “integrity of standby letters of credit”).

76. This mechanical reliability is comparatively more important for the *sales* letter of credit than the standby instrument in that the transaction involved in the former arrangement consists of clearly defined sequential steps, with the seller completing his duties long before the buyer receives the goods. Payment by the *sales* letter is needed before that last step, in order to finance the trade. In the standby transaction, however, the parties involved are likely to deal with each other over a period of time, requiring a greater judicial awareness of all the circumstances involved, while payment generally occurs in installments and should not involve the standby letter.

77. 356 F. Supp. 991 at 999.

78. *Merchants Corp. v. Chase Manhattan Bank*, 5 U.C.C. Rep. Serv. (Callaghan) 196 (N.Y. Sup. Ct. Mar. 5, 1968).

specified goods as of February 13 of that year.⁷⁹ The customer's challenge was thus based on the underlying transaction, and not on the sales letter of credit sub-contract between the customer and the issuer. As Henry Harfield has warned: "[w]here the functional distinction between the letter-of-credit transaction and the underlying transaction becomes increasingly difficult to perceive, it becomes increasingly difficult to maintain the legal distinction."⁸⁰

One may analogize the present problems in trying to maintain the myth that standby and sales letters of credit are functional, and therefore legal, equivalents, with the problems presented by the *Julia*, in the case of *Comptoir d'Achat v. Luis de Ridder*.⁸¹ At stake in that case was the certainty of another pillar of international trade: the c.i.f. contract.⁸² The House of Lords decided that despite the explicit use of the phrase "c.i.f." in the contract, despite the fact that payment was to be made "in exchange for" specified documents, and despite the fact that the sellers procured the insurance covering the rye, the contract was *not* c.i.f. in its effect when consideration was given to the true construction of the contract and the surrounding circumstances. In so deciding, it can be argued that the Lords preserved the certainty of the conventional c.i.f. contract, so that traders would comply with the policy purposes of such an arrangement (e.g., providing genuine bills of lading instead of documents not fully passing title of the goods but which "amounted only to a preliminary step towards performance").⁸³

Just as the term "c.i.f." was not in itself a "magic phrase," but rather had to be confirmed by the realities of the arrangement, so too the use of the phrase "letter of credit" should not be exclusively determinative of the legal doctrines that should be applied to any given financial arrangement. Instead the law of "letters of credit" should be reserved for instruments that conform to the traditional usage implied by that

79. *Id.*

80. Harfield, *supra* note 16 at 256. See also *supra* Justice, note 8, at 502 (criticizing decision in particular sales letter of credit case, but using criteria developed in two standby letter cases, ironically indicating confusion between the two instruments).

The courts have blurred the line between the underlying transaction and the letter of credit arrangement in a number of domestic cases as well, see, e.g., *Shaffer v. Brooklyn Park Garden Apartments*, 250 N.W.2d 172, 180 (Minn. 1977) (holding that allegation of fraud in bad faith call case by beneficiary was "appropriate for injunctive relief since it concerns the certifications"). See also *NMC Enterprises, Inc. v. Columbia Broadcasting Sys.*, 14 U.C.C. Rep. Serv. (Callaghan) 1427, 1429 (N.Y. Sup. Ct. 1974) (holding "where the documents or the underlying transaction are tainted with intentional fraud the draft need not be honored by the bank, even though documents conform on their face . . . and the courts may grant injunctive relief restraining such honor. . . ." (emphasis added)).

81. [1949] 1 All E.R. 269 (H.L.).

82. See generally A. LOWENFELD, *supra* note 1, at 5-40.

83. Gower, *C.I.F. Contracts*, 12 MOD. L. REV. 241, 243 (1949).

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phrase, and not for functional or “psychological opposite[s]”⁸⁴ such as the standby letter.

IV. New Bottles for New Wine: Towards a Standby Letter Doctrine

A. *The Need for a Distinct Approach*

As each of the three arrangements involved in the sales letter of credit is at least analogous to a contract,⁸⁵ the independence principle is meaningful in that context. The lack of consideration in the arrangement between the issuing bank and the beneficiary⁸⁶ and the greater importance of the circumstances surrounding the entire transaction⁸⁷ makes this principle effectively and theoretically tenuous in the standby context. The standby letter is substantively more similar to the guarantee than to the sales letter of credit, although the fact that the ultimate liability of default lies with the customer, rather than the bank, strains this analogy as well.⁸⁸

As yet, no framework has been devised that firmly distinguishes the standby instrument from the sales letter of credit.⁸⁹ Law journal notes and articles have posited a wide range of other solutions, which may generally be categorized as either admonitions to the courts to set “reasonable” standards for “fraud in the transaction,”⁹⁰ or proposals of so-

84. Harfield, *supra* note 16, at 258. *See also* Note, *supra* note 8, at 1015, which Note, although not providing a solution to the problems caused by the non-differentiation of standby and sales letters of credit, does observe that the failure to change existing legal practice “risks not only damage to the unwary customer but also haphazard judicial reaction that would affect letter of credit law with respect to both standbys, where change is needed, and traditional letters of credit, where it is not.” *Id.*

85. *See supra* text accompanying notes 12-15. For at least eye-winking questioning of the validity of each of the three contracts supposedly involved, see J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-2 (letter of credit never, strictly speaking, a contract, as beneficiary does not enter into agreement directly with issuer). In that the beneficiary’s documents are valuable, a unilateral contract could be presumed in the sales letter of credit context. Perhaps a more serious objection is made at note 14, *supra*.

86. *See supra* text accompanying notes 20-22.

87. *See supra* note 76.

88. *See supra* text accompanying notes 26-28. The guarantor’s liability is secondary to that of his customer, that is, the guarantor has *ultimate* liability for the default. In contrast, the customer under the standby letter is ultimately liable to the issuing bank, who pays the beneficiary directly.

89. *But see* Note, *supra* note 8, at 1013 (asserting that Iranian letter of credit litigation “forced courts interpreting the Code to confront what bank regulators have known for years: standby letters of credit are not the same as traditional letters of credit and should not be treated in the same way”). However, the affirmance of the independence principle and the reinterpretation of the “fraud in the transaction” exception by the courts demonstrate that the legal treatment is still the same for both instruments.

90. *See, e.g.*, Comment, *supra* note 18, at 210 (proposing that court should examine the

lutions specifically applicable to the Iranian circumstances,⁹¹ or suggestions of steps the customer should take to protect himself.⁹²

circumstances implied by terms of credit). "Once the conduct of the beneficiary falls below the level which the customer would reasonably expect . . . the legitimate 'purpose' of the independent contracts rule is no longer served." *Id.* That Comment also proposes that the court examine the underlying state of affairs for certain unjust enrichment situations justifying an injunction. As the Comment itself observes; however, this proposal "fails in certain respects to provide a principled basis for deciding letter of credit injunction actions." *Id.* at 212-13 n.125.

See also Note, *supra* note 11 (proposing "balancing test" between commercial utility and protection from fraud, and that courts examine claim of fraud in underlying transaction, rather than "merely" verify accuracy of documents; also suggesting language changes in U.C.C. to that effect). However, the standard suggested requires the plaintiff to show "an element of intentional misrepresentation" by the beneficiary and that the plaintiff meet the requirement for equitable relief. *Id.* at 515. Such requirements were essentially what the courts in the Iranian litigation *did* require, with unsatisfactory results. Further, U.C.C. § 5-114 on "fraud in the transaction" does not apply to several key jurisdictions, e.g., New York, which applies the U.C.P. provisions. The Minnesota Note finally fails to differentiate the *standby* from the *sales* letter, *id.* at 495-96, thereby exposing the latter instrument to law made from "hard cases" in the different, *standby* context.

91. See, e.g., Note, *supra* note 12, at 484-88, 493-94 (discussing a "politically-motivated demand" exception to strict enforcement of *standby* letter of credit obligations. The leading case espousing this exception, according to Note, is supposed to be the *Dynamics* opinion, *supra* text accompanying notes 53-58. *Id.* at 484-85. Note concludes that Iranian cases demonstrated that courts would apply "politically-motivated demand" exception only in "most egregious cases" of such demand, in which category no Iranian case apparently could be characterized. *Id.* at 503).

It is unlikely, however, that the courts would intervene in truly "politically-motivated demand" cases, given the Act of State problems such a characterization would involve, even assuming such motivation could be proved. See, e.g., *American Bell Int'l Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420, 423 (S.D.N.Y. 1979) (accepting determination of United States Government that new Islamic administration in Iran was legal successor of government with which Bell had contracted, so that even though only "Imperial Government of Iran" was to have been authorized to call on *standby*, Islamic Republic could do so with benefit of strict independence principle, *id.* at 424; the court further refused to "presume bad faith on the part of the Iranian government," *id.* at 425).

More fundamentally, the *Dynamics* case was not explicitly decided on "politically motivated" grounds, but more realistically reflected the court's recognition of that company's situation of bankruptcy, see *supra* note 58.

Finally, although it refers to the disparity of bargaining power in the Iranian contracts, the Note asserts that the private parties involved assumed the risk of "political uncertainty." Note, *supra* note 12, at 503-04. However, the risk of a bad faith call goes beyond such conventional "risk-allocation" paradigms, as the risk of bad faith can not be allocated in a contract which must conclusively assume *good faith* in order to be valid at all. See also Comment, *supra* note 18, at 245-46 (proposing that temporary injunction should issue where "a sovereign beneficiary causes a radical or revolutionary change in its municipal law or judicial processes"; cf. Cuban cases, *supra* note 51. This standard would "operate only in the event of a radical suspension of private rights which sometimes [N.B.] accompanies a revolutionary political change." *Id.* at 246). While unobjectionable as far as it goes, this proposal further requires that the customer carry the burden of proof. *Id.* at 221. In effect, this proposal does not differ so much from the admonition to look at all the circumstances surrounding the transaction. The admonition was available to the courts in the Iranian litigation, which did, after all, produce a number of notice injunctions. The difficulties of providing clear standards, procedures, and an analytical framework remain.

92. See, e.g., White, *supra* note 5, at 131 (urging customer to rely on good faith generally present in international trade or to take out insurance; latter proposal would clearly raise

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The first two types of solution continue to require that the plaintiff carry the burden of proving the "fraud," however that "fraud" be defined. The remedy advised continues to be injunctive, while the court is to have a broader scope of review and hence, discretion. The standards to be met or to be applied continue to be vague as well, with the possible exception that initial "notice" injunctions may be easier to obtain.⁹³ The effect of these proposals, then, seems to be an appealing attenuation of the independence principle without, however, adequately protecting the sales letter of credit from the increased litigation likely to result. No penalties exist for bringing a suit for temporary injunction, so that customers may perceive this process as an effective delaying tactic.

The third type of solution, though prudential, either ignores reality or is content with it. The fundamental problem of differential bargaining power is ignored as is the need to provide a financial guarantee instrument that offers a sovereign beneficiary the means to maximize reasonable control over the customer's performance under the contract with a minimum of judicial involvement.

B. *The Standby Letter and the Principle of Replevin: A Common Law Solution*

Accepting the need for distinguishing the standby from the sales letter of credit, as well as the need for a "principled basis"⁹⁴ for dealing with bad faith calls on standby letters without adversely affecting the policy served by the standby instrument, the task remains to fill that need. This Article's analysis of the unique function fulfilled by the standby letter of credit suggests a common law solution to the problem.

Rather than analogizing the standby letter to either the sales letter of credit or the guarantee, it seems more appropriate to view this arrangement as a provision in the underlying contract governing the payment of liquidated damages in case the customer defaults, with the issuing bank performing as the customer's agent. The funds used to pay these

price of doing business internationally and would not obviate burden of proof problem should insurance policy require customer to establish his lack of fault). *See also* Note, *supra* note 8, at 1014 (suggesting that customers draft their letters of credit in such way as to require certification of default or other forms of protection). However, given the tremendous bargaining power possessed by many beneficiaries, *id.* at 993 n.9, such steps are improbable. Thus, White, *supra* note 5, at 129-31, discusses the 1978 action taken by the International Chamber of Commerce, whose UNIFORM RULES FOR CONTRACT GUARANTEES include an article requiring some form of objectivity in allowing a call on a standby letter, as well-intentioned but unlikely to be incorporated into the contracts of major buyers.

93. *See supra* note 91.

94. Comment, *supra* note 18, at 213 n.125.

liquidated damages effectively belong to the customer, but are conceptually held by the bank in escrow.

If the beneficiary makes a bad faith call on this arrangement, an award by the bank of such funds would constitute a "wrongful taking" by the beneficiary of property belonging to the customer.⁹⁵ To prevent this wrongful taking, the customer would be allowed to institute an action based on the principle of replevin.

Care must be taken to institute this action in such a way as to ensure constitutionally adequate due process to the claiming beneficiary.⁹⁶ While not an exclusive guide to the initiation of such process the customer should:

(a) show facts supporting his right to possession, by verified allegations that state that the customer has fulfilled all his obligations under the contract, and that therefore a call on the standby provision is not warranted;

(b) post a bond sufficient to pay for the attorney's fees of the beneficiary should the beneficiary prevail at the hearing;⁹⁷

(c) present the allegations in (a) to a judicial officer who shall determine the bond in (b); and

(d) participate in a prompt hearing.⁹⁸

The character of the allegations needs to be further specified. The basic conception behind these allegations is to focus the court's attention on the duties and performance of the customer, and not on the difficult task of showing "active intentional fraud."⁹⁹ Further, evidence of the actions of the plaintiff/customer may be far less difficult to ob-

95. A necessary condition for the right to institute an action in replevin is that the plaintiff be entitled to "immediate possession." See, e.g., *Bohlen v. Arthurs*, 115 U.S. 482 (1885).

96. The requirement of due process has generally been interpreted as the provision of some kind of notice to the party allegedly in wrongful possession of the property in question, an opportunity to be heard promptly, and a hearing before a judicial officer before the property is seized by the original owner. See, e.g., *North Ga. Finishing, Inc. v. Di-Chem, Inc.*, 419 U.S. 601 (1975); *Fuentes v. Shevin*, 407 U.S. 67 (1972). But see *Mitchell v. W.T. Grant Co.* 416 U.S. 600 (1974) (upholding constitutionality of Louisiana statute permitting judge to issue "writ of sequestration" upon filing of bond and affidavit by the seller-creditor). See generally Newton, *Fuentes 'Repossessed' Reconsidered*, 28 BAYLOR L. REV. 497 (1976).

97. The award of attorney's fees and other damages to the defendant in addition to the property "seized" in the event plaintiff is unable to sustain the action in replevin is common. See, e.g., *Trilon Plaza Co. v. Allstate Leasing Corp.*, 399 A.2d 34 (D.C. App. 1979); *Meeker v. Beeson*, 76 Ill. App. 3d 940, 395 N.E.2d 698 (1979); *Akins v. Pierce*, 563 S.W.2d 406 (Ark. 1978).

98. For a case setting out these four requirements, see *Gazil, Inc. v. Super Food Services, Inc.*, 356 So.2d 312 (Fla. 1978).

99. *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 16 (2d Cir. 1979) (quoting *American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co.*, No. 3157/79 (Sup. Ct. N.Y. Mar. 26, 1979), *aff'd*, N.Y.L.J., June 28, 1979, at 6, col. 1) (N.Y. App. Div.). On the appropriate focus for the courts' attention, see *supra* note 62.

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tain and examine than that of the sovereign beneficiary. At the same time, the allegations provide a specific agenda for the hearing and will tend to concentrate the discovery process and thereby save time and expense.¹⁰⁰

In answering the action, the defendant beneficiary must convince the court of the inaccuracy of the plaintiff's allegations, showing that a default did occur and that, therefore, it is entitled to payment under the standby letter as well as the bond posted by plaintiff as a condition for instituting the action. If the defendant has called on the standby instrument in good faith, it should be able to carry this affirmative duty with ease, given that the performance and default is to have occurred within its territorial boundaries.¹⁰¹

The requirement that the plaintiff post a sufficient surety bond in order to institute the replevin-like action ensures that the customer will not "lightly undertake"¹⁰² such action. Given this feature, together with the limited agenda to be considered by the courts and the requirement of a prompt hearing, this approach should be acceptable internationally. Finally, it should be emphasized that this approach is *analogous* to replevin, but not identical to it. It is much narrower than that action. It is concerned only with a specific monetary commitment on the part of the customer, under the standby instrument, a commitment the customer alleges is wrongfully claimed by the beneficiary. Conventional strictures against non-monetary relief in the international context are therefore not violated.¹⁰³

V. Evaluation and Conclusion

Chief among questions that this approach may raise are those of jurisdiction and choice of law. While the Foreign Sovereign Immunities Act¹⁰⁴ generally allows suits against foreign states in United States courts, insofar as such suits concern the commercial activity and property of those states,¹⁰⁵ a defense against such suits may still exist under

100. *Cf. Dalmia Dairy Indus. Ltd. v. Nat'l Bank of Pakistan*, [1978] 2 Lloyds L.R. 223 (arbitral proceedings, mandated by I.C.C. rules concerning defendant bank's failure to pay "on-demand" guarantee, required ten years from start to finish). *See also supra* note 68 (arbitration in *Sperry* case expected to last at least two years during which time funds committed under standby letter will be in escrow).

101. *See supra* text accompanying note 58.

102. *Fuentes v. Shevin*, 407 U.S. 67, 101 (1972) (White, J., dissenting).

103. *See* H. STEINER & D. VAGTS, *TRANSNATIONAL LEGAL PROBLEMS* 638 (2d ed. 1976).

104. 28 U.S.C. §§ 1602-1611 (1976).

105. *Id.* at § 1602.

the Act of State doctrine.¹⁰⁶ Some jurists, however, have argued that the Act of State doctrine does not apply to commercial acts of the foreign state, "even if performed inside its territory."¹⁰⁷ Moreover, because the sums of money involved will tend to represent relatively smaller amounts for sovereign beneficiaries than for the performing parties and because the policy of furthering international trade is best served by disallowing bad faith calls, judicial tests favoring a balancing of interests in deciding whether to permit the Act of State defense would tend to deny that defense in "bad faith call" cases.¹⁰⁸

The question of "choice of law" needs to be considered as well. As the action in replevin is grounded in common law, with the property sought to be replevied in the United States if the issuing bank is located there, it might seem likely that the law of that forum would be applied. This likelihood exists even should the contract be negotiated or concluded in the foreign country.

It is important to stress that standby instruments should be considered as legally distinct from sales letters of credit. The current legal treatment of both standby and sales instruments is largely defined in the international context by the Uniform Customs and Practice for

106. See Comment, *supra* note 18, at 214 n.127. Whether the Act of State defense is limited by the restrictive theory of sovereign immunity is a matter of considerable dispute. Justice White, joined by only two other justices in *Alfred Dunhill of London, Inc. v. Cuba*, 425 U.S. 682 (1976) (5-4 decision), opined that it *was* so limited. *But see Int'l Ass'n of Machinists and Aerospace Workers v. OPEC*, 649 F.2d 1354, 1359 (9th Cir. 1981) (holding that successful Act of State defense could be made where no sovereign immunity could be claimed).

107. L. HENKIN, R. PUGH, O. SCHACHTER, H. SMIT, *INTERNATIONAL LAW* 516 (1980). Note also the Second Hickenlooper Amendment, 22 U.S.C. § 2370(e)(2), requiring United States courts to "make a determination on the merits giving effect to the principles of international law," on claims based upon a taking after January 1, 1959. The Amendment did *not* apply to claims or rights acquired "pursuant to an irrevocable letter of credit of not more than 180 days' duration issued in good faith prior" to the taking. *Id.* at 133 (emphasis added). To the extent that this exception, enacted in 1965, is not overruled by the F.S.I.A., it is interesting to note that it limits the duration of such "letters of credit" to 180 days. To the extent standby letters are included in this term, most are issued for terms coincident with the underlying contract, which in turn generally extend for periods significantly longer than six months. It could even be argued, then, that the Hickenlooper Amendment created a "safe haven" uniquely for standby letters.

108. See, e.g., *Mannington Mills, Inc. v. Congoleum Corp.*, 595 F.2d 1287, 1296 (3d Cir. 1979) (requiring "weighing of competing interests" before determining whether foreign sovereign act in conflict with U.S. antitrust laws should be treated as Act of State; holding against such treatment); *Timberlane Lumber Co. v. Bank of America*, 549 F.2d 597, 606 (9th Cir. 1976) ("[w]hether forbearance by an American court in a given situation is advisable or appropriate depends upon the 'balance of relevant considerations,'" *citing* *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 428 (1964)). The *Timberlane* court went on to quote from the *Sabbatino* decision that "the less important the implications of an issue are for our foreign relations, the weaker the justification for exclusivity in the political branches." *Id.* at 607 (*quoting* 376 U.S. 398, 428).

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Documentary Credits,¹⁰⁹ which does not distinguish between the two. Treating the standby instrument in the manner proposed by this Article would not conflict with these general rules if the court differentiates between the two arrangements.

Moreover, the international commercial community appears to be looking for an alternative treatment of standby letters that would avoid the problem of bad faith calls.¹¹⁰ By applying the doctrine set out in this Article, courts would thus form international law in conformity with the changing needs of that community, while basing such doctrine on traditional legal principles.¹¹¹

Such concern abroad further indicates that judicial application of this approach will not prejudice American commercial interests. The strict requirements on the plaintiff, including the posting of an adequate bond which would be forfeited should the beneficiary/defendant successfully demonstrate that default had occurred, would ensure that whatever litigation is brought would not be frivolous. In particular, cases could not be brought before a call is actually made¹¹² as no "wrongful taking" could be alleged. Should litigation occur, the specific nature of the allegations required, focusing on the duties of the plaintiff, together with the correspondingly specific issues for rebuttal by the defendant, as well as the requirement of a prompt hearing, all indicate that such litigation would be neither lengthy nor costly. This "specificity" feature in turn would tend to encourage contractors performing under a standby instrument to document the fulfillment of their contractual duties as such performance progresses.

109. See generally Eberth, *Documentary Credits in Germany and England*, 1977 J. BUS. L. 29. See also Comment, *supra* note 18, at 201.

110. See, e.g., White, *supra* note 5, at 129-31 (discussing International Chamber of Commerce Uniform Rules for Contract Guarantees that require greater degree of objective substantiation for calls made on standby instruments).

111. The courts have based decisions on general principles in the face of technical legal arguments. See, e.g., *Upright v. Mercury Bus. Machines Co.*, 13 A.D.2d 36, 213 N.Y.S.2d 417 (App. Div. 1961) (holding against defendant who sought to dishonor a trade acceptance assigned to plaintiff by an East German corporation on grounds that acceptance was invalid, as such corporation was an arm of foreign government not recognized by United States; such dishonor constituted unjust enrichment, which, absent an affirmative defense as to public policy, would not be allowed under principles of international law).

112. The majority of cases brought in the Iranian litigation were initiated in anticipation of a wrongful call, not on a call actually made. Thus, although KMW was correct in contending it could not possibly be made to pay on a standby issued before any duty to perform had matured on KMW's part, it would have been dismissed under this approach until such a call was actually made. See *KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979). The possible provocation of bad faith calls, in response to an attempt to enjoin such a call by the customer before actually made, would thus be avoided under this approach. See generally Lambert & Coston, *Friendly Foes in the Iranian Assets Litigation*, 7 YALE J. WORLD PUB. ORD. 88 (1980).

Most important, providing a reliable remedy to victims of bad faith calls increases certainty in international commerce. The "customer" in the standby arrangement will have greater confidence that that arrangement will operate in the intended manner. His total payment under the contract will therefore be more certain, enabling him to seek a lower price commensurate with this lesser uncertainty.¹¹³ Similarly, the issuing bank will be less exposed to the risk that a bad faith call might bankrupt the paying customer, thereby leaving the bank with the obligation. The "beneficiary" will in the great majority of cases be assured of the intended and unimpaired functioning of the standby instrument, with less fear of unjust litigation delaying payment under a call than is presently the case. Should a wrongful suit be brought by the customer, the beneficiary may be expected not only to win the amount under the standby after a prompt hearing, but will also be entitled to plaintiff's security bond. The traditional sales letter of credit will be spared further confusing encroachments on its common law doctrine, thereby enhancing certainty under that instrument as well. Finally, with greater certainty all around, more private firms and public commercial entities will trade, with the net result being the enhancement of "increased dealings to the mutual satisfaction of all interested parties."¹¹⁴

Will the courts accept arguments and requests for the remedy based on this Article's approach? On one level, there is no apparent reason why courts should not adopt the remedy developed in this Article. The approach is based completely on the common law, and would therefore not require any appeal to equity or judicial discretion. To that extent, parties that had sought injunctions based on the "fraud in the transaction" exception of the sales letter of credit doctrine have simply based their pleadings upon the wrong legal theory.

To the extent that this approach seems too new to the courts, some appeal to fundamental principles of law may be necessary before such courts may be willing to entertain this approach. The courts¹¹⁵ and

113. See *Jarvis*, *supra* note 19, at 359.

114. *Banco Espanol de Credito v. State Street Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967).

115. See, e.g., *Alfred Dunhill of London, Inc. v. Cuba*, 425 U.S. 682, 702 (1976) ("enormous increase in the extent to which foreign sovereigns had become involved in international trade made essential 'a practice which will enable persons doing business with them to have their rights determined in the courts'"); *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 453 (1964) (White, J., dissenting) ("[f]undamental fairness to litigants as well as the interest in stability of relationships and preservation of reasonable expectations call for [the application of principles of international law] . . . whenever international law is controlling in a case or controversy"); *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*,

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arbitration tribunals¹¹⁶ have exhibited a willingness to hear the claims of private parties injured in their commercial dealings with sovereign entities and to “do justice.” In the interests of furthering international economic activity, it is to be hoped they may be willing to do so in this context as well.

356 F. Supp. 991, 999 (N.D. Ga. 1973) (“[T]he court views its task in this case as merely guaranteeing that India not be allowed to take unconscientious advantage of the situation and run off with plaintiff’s money on a *pro forma* declaration which has absolutely no basis in fact”). See also *supra* note 110.

116. See, e.g., *Sapphire-N.I.O.C. Arbitration*, *transl. in* 13 INT’L & COMP. L.Q. 987, 1015 (1964); 35 I.L.R. 136, 175 (1963) (Cavin, Arb.) (arbitrator should decide cases according to “general principles” of positive law, “common to civilized nations” in order to give “guarantees of protection which are indispensable for foreign companies, which undergo very considerable risks in bringing financial and technical aid to countries in the process of development”); DEP’T OF STATE, *El Triunfo Case*, in [1902] FOREIGN RELATIONS OF THE UNITED STATES 859, 871-72 (“It is abhorrent to the sense of justice to say that one party to a contract, whether such party be a private individual, a monarch, or a government of any kind, may arbitrarily, without hearing and without impartial procedure of any sort . . . impose upon him the extreme penalty of forfeiture of all his rights . . . made on the faith of that contract [A]ll parties to a contract . . . are equally entitled to invoke for their redress and for their defense the hearing and judgment of an impartial and disinterested tribunal.”).