

THE STANDBY LETTER OF CREDIT: VALUABLE BUT STILL UNCERTAIN INSTRUMENT IN INTERNATIONAL BUSINESS TRANSACTIONS

I. INTRODUCTION

A. Statement of the Problem

Parties to international standby letters of credit are frequently unaware of the functional and legal implications of this unique financing instrument. Assuming a standby letter of credit will never be drawn upon, banks and their customers do not realize the significance of the obligations to which they bind themselves. Beneficiaries are unaware of the legal uncertainties still surrounding standby letters of credit, uncertainties which may serve to defeat their drawing rights. Faced with ambiguities in the law, courts have been inconsistent in this area; consequently, uncertainty has been compounded.

Because the standby letter of credit is an immensely valuable financing tool, especially in international transactions, it will continue to be used by businessmen and bankers. To reduce their exposure, parties to standby letters of credit should be aware that the law and practice surrounding standbys are still in a state of flux. In order to avoid nonenforcement of an instrument that parties intended to be a standby letter of credit, businessmen, bankers, and their lawyers must focus on the settled issues in the law and practice of standby letters of credit and rigorously comply with them. By doing so, parties to standby letters of credit can contribute to the stability of the instrument and help create new law and practice that will resolve the inconsistencies and uncertainties that now exist.

*B. Scope of This Study and Distinction Between Traditional and Standby Letters of Credit*¹

This study focuses on standby letters of credit² and deals with traditional letters of credit only to the extent they have exercised an influence on standbys. The traditional letter of credit finances a sale of goods, usually over long distances, between parties who are not sure of each other's dependability or creditworthiness.³ The standby letter of credit differs from the traditional letter of credit in that it finances or secures an underlying debt such as a promissory note, or an underlying performance such as completion of a construction contract.⁴ Because it performs these functions, the standby resembles a guaranty or a performance bond: there is a presumption that the standby will not be drawn upon and that its purpose is merely to guarantee payment or performance.

The traditional and the standby letter of credit share certain fundamental characteristics: both create an absolute obligation on the part of the issuer to honor drafts against the letter of credit.⁵ The only permissible condition to that obligation is that the beneficiary present documents complying in all respects with the requirements of the letter of credit.⁶ The issuer's obligation to pay is totally independent of any

1. There are three essential parties and three essential contracts to any letter of credit transaction. The essential parties are the issuer, the account party, and the beneficiary. The issuer is a bank or other individual or entity that drafts the letter of credit contract. It issues the letter of credit at the request of its customer, the account party. The issuer and account party enter into a separate contract under which the account party promises to pay the issuer any funds which are paid out pursuant to the letter of credit. The letter of credit itself is a contract between the issuer and the beneficiary who will receive money according to the terms of the letter of credit. The letter of credit is independent of the underlying contract between the account party and the beneficiary. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 719-20 (1973) [hereinafter cited as Verkuil]; Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 112 (Tex. 1979).

2. In 12 C.F.R. § 7.1160(a) (1978), the Comptroller of the Currency has defined a standby letter of credit as:

[A]ny letter of credit, or similar arrangement however named or described which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation.

3. Justice, *Letters of Credit: Expectations and Frustrations*, 94 BANKING L.J. 424, 427-28 (1977) [hereinafter cited as Justice].

4. The Comptroller of the Currency has distinguished the standby letter of credit from the traditional letter of credit:

[T]he term "standby letter of credit" does not include commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer, which do not "guaranty" payment of a money obligation and which do not provide for payment in the event of default by the account party.

12 C.F.R. § 7.1160 n.1 (1978).

5. Justice, *supra* note 3, at 428-29.

6. For a discussion of the standards of compliance of documents to the letter of credit,

other contract so that the obligation continues even though there is a breach of the underlying contract.⁷ The issuer is interested in documents alone, not in performance.⁸

C. Organization of This Study

This study begins by considering the settled issues in the law and practice of standby letters of credit.⁹ The basic premise is that standby letters of credit are extremely valuable instruments in international transactions. The primary settled issue is that standbys are legal as long as they create an absolute obligation on the part of the issuer to pay the beneficiary upon the receipt of documents complying with the terms of the letter of credit.

After a consideration of the settled issues, the study identifies the forces which mitigate the effect of the settled issues by undermining the stability of the law and practice of standby letters of credit.¹⁰ These forces include the varying role equity is allowed to play in enforcement or nonenforcement of alleged standby letters of credit and the fact that banks, relying on uncertainties and inconsistencies, have disavowed their obligations under standby letters of credit. Banks have done so claiming such defenses. Banks may argue the purported standby letter of credit was void because it was in reality an illegal guarantee. Alternatively they may argue the particular standby should be void because standby letters of credit are against public policy in that they are inherently threatening to bank solvency.

see T. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 620-23 (1972) [hereinafter cited as WHITE & SUMMERS]. White and Summers point out that the standard is a sliding one. In a suit by the beneficiary against the issuer that refused to honor the documents presented by the beneficiary, the standard is strict compliance. That is, the bank may refuse to honor the documents if they do not conform in every respect to the requirements of the letter of credit. However, after the issuing bank has honored the documents presented by the beneficiary and has paid under the letter of credit, the standard is reasonable compliance in a suit by the bank against its customer. In other words, the bank may enforce reimbursement from its customer if the documents presented by the beneficiary were in reasonable compliance with the requirements of the letter of credit. The customer may not defend nonpayment to the bank by claiming the documents were not in strict compliance with the letter of credit.

7. See U.C.C. § 5-109(1)(a) (1972 version): "An issuer's obligation to its customer includes good faith and observance of any general banking usage but unless otherwise agreed does not include liability or responsibility for performance of the underlying contract for sale or other transaction between the customer and the beneficiary."

8. For a discussion of the proposition that guarantees are concerned with performance, whereas letters of credit are concerned with documents, see W. WARD & H. HARFIELD, BANK CREDITS AND ACCEPTANCES 133-34 (4th ed. 1958) [hereinafter cited as WARD & HARFIELD]. For the idea that banks deal with documents alone and not with merchandise in commercial letters of credit see UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS art. 10.

9. See text, Section II *infra*.

10. See text, Section III *infra*.

The study then discusses efforts that have been made to resolve these uncertainties and inconsistencies before concluding that these efforts have had only limited success and must be modified and continued.¹¹

II. SETTLED ISSUES

A. Commercial Value of Standby Letters of Credit

The commercial value of the standby letter of credit in international business transactions is uncontested. Because of its flexibility, the standby letter of credit has evolved to fulfill functions that cannot be fulfilled adequately by any other instrument. The standby letter of credit is uniquely suited to serve as a low cost performance bond or a bid bond for a construction contract between parties of different nations.¹² A party granting a construction contract may require a performance bond as protection against failure of the contractor to perform his obligations.¹³ Should the contractor fail to perform, the injured grantor can recover by drawing on the security contract (performance bond or standby letter of credit). An important advantage the standby letter of credit has over the bid bond and performance bond is that collection under the standby is automatic upon presentation of complying documents. Immediate payment without recourse to judicial process, a feature that performance bonds and bid bonds do not share, is particularly important in transactions where the parties are from distant countries.

Most foreign countries do not have well-developed surety industries.¹⁴ The business of offering performance insurance is non-existent in socialist countries.¹⁵ American surety companies, unlike American banks, do not have adequate international standing for their bonds to be accepted abroad.¹⁶ Performance bonds may be difficult for small

11. See text, Section IV *infra*.

12. Examples of international letters of credit were obtained from interviews with Lea Resende, Texas Commerce Bank, in Houston, Texas (October, 1978) and with Partha Council, Bank of Tokyo, in Houston, Texas (February, 1979).

13. A possible alternative to a construction bond is for the party awarding the contract to retain money from progress payments owed to the contractor—usually 5% to 10% of each progress payment—to secure proper performance of the construction contract. There are, however, disadvantages to this method: “[retention moneys] accrue only as and when the contractor becomes entitled to progress payments, and the contractor may have run into financial difficulties preventing him from performing the contract already before the retention fund has reached a size sufficient to serve as protection. . . .” G. WESTRING, UNITED NATIONS INSTITUTE FOR TRAINING AND RESEARCH, INTERNATIONAL PROCUREMENT: A TRAINING MANUAL, 37 (1977) [hereinafter cited as INTERNATIONAL PROCUREMENT].

14. WARD & HARFIELD, *supra* note 8, at 136.

15. INTERNATIONAL PROCUREMENT, *supra* note 13.

16. WARD & HARFIELD, *supra* note 8, at 136. The Board of Governors of the Federal Reserve System has stated that the unavailability of letter of credit facilities would place

contractors to obtain;¹⁷ surety companies grant them only after a thorough investigation of a contractor's experience and ability.¹⁸

A "steamer guaranty"¹⁹ is another form of standby letter of credit that plays an important role in international business transactions. It is used in international sales of goods. When goods purchased in an international sales transaction arrive before the documents required by a carrier or by a traditional letter of credit, the purchaser cannot take possession of the merchandise for lack of proper documentation. The purchaser does not want to leave the goods on the dock while awaiting the arrival of the documents because there they are exposed to natural and man-made risks and to storage charges. The solution to the dilemma is for the bank to issue a steamer guaranty. Upon the request of its customer, the purchaser,²⁰ the bank issues a guaranty assuring the carrier that the bank will be responsible directly to it in case the required documents fail to arrive or to comply. Carriers are generally willing to rely on the promise of a bank. This version of the standby credit thus allows a purchaser to remove merchandise from the dock soon after its arrival, even if the required documents are delayed.

Standby credits can also secure payments in international performance or sale of goods transactions. For example, *ABC*, an American corporation, may be reluctant to enter into a contract with *XYZ*, a foreign corporation, because it does not know if it can rely on *XYZ*'s promise to pay. *ABC*, however, is willing to rely on the promise of a local bank. A common practice is for *XYZ* to have its own bank contact an American bank to issue a letter of credit in favor of *ABC*. The letter of credit usually stipulates that the bank will pay *ABC* a specified amount if *XYZ* fails to pay.²¹

The standby letters of credit can be characterized as unique, dependable, and flexible. They are unique in that they are the only financial instrument available to American bankers to compete with

U.S. businessmen at an unnecessary competitive disadvantage in foreign markets. Harfield, *Enjoining Letter of Credit Transactions*, 95 *BANKING L.J.* 596, 599 n.10 (1978) [hereinafter cited as *Enjoining*].

17. *INTERNATIONAL PROCUREMENT*, *supra* note 13, at 38.

18. *Id.* at 37.

19. *See WARD & HARFIELD*, *supra* note 8, at 141-42.

20. The purchaser often gives the bank a "counter-guaranty" to assure the bank that it, the purchaser, will be ultimately responsible in case the required documents fail to arrive or to comply. *Id.* at 141.

21. This letter of credit is a standby even though it is involved in a sale of goods transaction because its purpose is to guarantee payment by the purchaser. The parties do not expect it to be called upon; it will be called upon only if the purchaser fails to pay as required.

Examples of international standby letters of credit could be multiplied. The standby letter of credit has been characterized as "perhaps the most versatile tool in foreign trade." Harfield, *Secondary Uses of Commercial Credits*, 44 *COLUM. L. REV.* 899, 912 (1944).

bank guaranties issued by foreign banks.²² The dependability of the standbys is indicated by the fact that relatively little litigation has arisen from their use.²³ The dependability of standby letters of credit is such that they have been compared to a claim check redeemable at a bank's vault.²⁴ That is, they not only are reliable but also automatic: if the beneficiary presents the required documents, his draft will be honored without delay.

Standby letters of credit are also inexpensive. Because the bank's obligation is limited to its agreement in the letter of credit, the fee is small, approximately one to two percent of the amount of credit to be made available.²⁵ Fees are generally higher for sureties²⁶ because bonding companies issue bonds only after a thorough investigation of the customer's past record, current commitments, experience, financial standing, equipment, integrity, and professional ability.²⁷ When a breach occurs, the surety investigates the breach and sometimes litigates. On the other hand, when issuing a standby credit, the bank need only assess the creditworthiness of its customer and ascertain whether the beneficiary presented complying documents.

Standby letters of credit are known for their flexibility.²⁸ Flexibility arises partly from the absence of rigid legal requirements. The Comptroller of the Currency and Congress have recognized the value of flexibility in letter of credit law and have responded by promulgating only very broad regulations and statutes.²⁹ The Comptroller of the Currency has specified that federal regulations are intended to en-

22. See WARD & HARFIELD, *supra* note 8, at 135-38.

23. A letter of credit creates an "absolute obligation" on the part of the issuer, tending to discourage disclaimers of liability on the part of bank-issuers. See Justice, note 3 *supra*, at 428-29. Bank claims of no liability threaten the stability of a system based on the concept of absolute obligation. See text, Section III(C) *infra*. Some jurisdictions, such as Texas, have no case law in the area of standby letters of credit. See Republic Nat'l Bank v. Fort Worth Nat'l Bank, 578 S.W.2d 109, 112 (Tex. 1979).

24. Justice, *supra* note 3, at 424.

25. This approximation is only a very rough estimate. Prices reflect the bank's assessment of the risk it is undertaking. Verkuil, *supra* note 1, at 721 n.29.

26. Rates for performance bonds issued in the U.S. are as follows: \$12.00 per \$1,000 for the first \$500,000; \$7.25 per \$1,000 for the second \$500,000. A bond for a \$1,000,000 contract would thus cost \$9,625 whereas a standby credit serving the same purpose would cost approximately \$2,000. Figures for cost of performance bonds were provided in an interview with Sidney Ellis, Royal Globe Insurance Companies, Houston, Texas (January, 1979). Mr. Ellis stated that his company has not issued performance bonds for a number of years because the risk is too high.

27. INTERNATIONAL PROCUREMENT, *supra* note 13, at 37.

28. See, e.g., Wichita Eagle and Beacon Publishing Co. v. Pacific Nat'l Bank of San Francisco, 343 F. Supp. 332 (N.D. Cal. 1971), *rev'd*, 493 F.2d 1285 (9th Cir. 1974): "One of the reasons behind the growth and spread of the letter of credit as a commercial tool has been the willingness of the courts to align case law with progressive and current commercial practice." 343 F. Supp. at 338; WHITE & SUMMERS, *supra* note 6, at 610.

29. State and federal law and regulations governing standby letters of credit are as follows: U.C.C. art. 5; Comptroller of Currency, Export-Import Bank 12 C.F.R. § 1.160 (1979);

courage sound banking, but that failure to comply with them does not render a letter of credit void.³⁰ The dominant principle in Article 5 of the Uniform Commercial Code (U.C.C.), the article dealing with letters of credit, is freedom of contract.³¹ Code definitions are expansive.³² The expression "unless otherwise agreed" appears fifteen times throughout Article 5 so that certain sections of the statute become effective only to fill gaps which parties have left in their negotiations.³³ Section 5-102(3) and accompanying comments recognize that the law of letters of credit is still in a state of flux and that legislation must be construed liberally.³⁴ The implication is that parties can adapt letters of credit to their own needs and that courts may fashion law as they see fit as long as they observe "the fundamental theories underlying letters of credit."³⁵

B. *Legality of Standby Letters of Credit*

The legality of a standby letter of credit has proved to be more controversial than its commercial value, although it is now generally accepted that such instruments are legal. Article 5 of the Uniform Commercial Code presumes the validity of a document conspicuously stating it is a letter of credit.³⁶ Section 5-103(1)(b) specifies that letters of credit requiring notice of default to trigger payment (*i.e.*, standbys) are valid instruments. They have received the imprimatur of the principal banking agencies: the Comptroller of the Currency,³⁷ the Federal

Federal Reserve System, Banking Practices 12 C.F.R. § 208.8(d) (1979); Federal Deposit Insurance Corp., Unsafe and Unsound Banking Practices 12 C.F.R. § 337.2 (1979).

30. Concerning his May 5, 1977 revision of 12 U.S.C. § 7.7016, the Comptroller stated:

As revised, the ruling makes clear that, while national banks for safe and sound banking purposes should issue their letters of credit in conformity with the ruling's standards, the determination of a letter of credit's legality and whether it should be honored is governed solely by statutory law such as the Uniform Commercial Code, or by convention, such as the Uniform Customs and Practice for Documentary Credits.

42 Fed. Reg. 24, 206 (1977).

31. WHITE & SUMMERS, *supra* note 6, at 610.

32. See U.C.C. § 5-103 (1972 version).

33. See Works, "Unless Otherwise Agreed" and Article 5: An Exercise in Freedom of Contract, 11 ST. LOUIS L.J. 416 (1967).

34. U.C.C. § 5-102(3) (1972 version) specifies:

(3) This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article.

35. U.C.C. § 5-102(3), comment 2 (1972 version).

36. U.C.C. § 5-102(1)(c) (1972 version): "This Article applies . . . to a credit issued by a bank or other person if the credit is not within subparagraphs (a) or (b) but conspicuously states that it is a letter of credit or is conspicuously so entitled."

37. 12 C.F.R. § 7.1160 (1978).

Reserve³⁸ and the Federal Deposit Insurance Corporation (FDIC).³⁹

Standby letters of credit have not always, however, received widespread recognition. Until only recently the issuance of standby letters of credit was challenged as an illegal activity for banks.⁴⁰ The legality of the traditional letter of credit, on the contrary, has not been questioned since the late 1940's.⁴¹

Generally speaking, the standby letter of credit has been challenged as being an unsound banking practice⁴² and as being *ultra vires* the business of banking. It has been alleged to be unsound in that the issuer's obligation is not secured by a title to goods as is the case of a traditional letter of credit. When the argument is made, it is alleged to be *ultra vires* because it serves as a guaranty and, apart from a few exceptions,⁴³ banks do not have the corporate power to guaranty obligations of others.⁴⁴ Only by looking at the checkered court record of the standby letter of credit and at the confusing historical development of the legality of all letters of credit is it possible to understand why the legality of the standby letter of credit was for so long the object of serious concern, even after it had been used extensively and successfully.

C. *Origin of the International Letter of Credit*

Letters of credit date back at least to the Italian cities of the 12th century⁴⁵ and perhaps even to the Phoenicians, Babylonians, Assyrians, and Greeks.⁴⁶ Because of the limited role of the United States in international business transactions, the traditional international letter of credit was not an important instrument in the U.S. until the second decade of this century. With the decline of European production and the decline of the pound sterling subsequent to World War I, U.S. participation in export sales increased and so did its use of international letters of credit.⁴⁷ Not until World War II were they issued regularly

38. 12 C.F.R. § 208.8(d) (1978).

39. 12 C.F.R. § 337.2 (1978).

40. See Justice, *supra* note 3, at 430-31.

41. Trimble, *The Implied Power of National Banks to Issue Letters of Credit and Accept Bills*, 58 YALE L.J. 713, 714 (1979) [hereinafter cited as Trimble].

42. See generally Battaile, *Guaranty Letters of Credit: Problems and Possibilities*, 16 ARIZ. L. REV. 822, 831 (1974); Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697, 704-05 (1975).

43. See text accompanying notes 144-48 *infra*.

44. See *Border Nat'l Bank v. Am. Nat'l Bank*, 282 F. 73, 77-78 (5th Cir. 1922), *cert. denied*, 260 U.S. 701, 732 (1922).

45. B. KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS* 3 (1966) [hereinafter cited as KOZOLCHYK].

46. Wiley, *How to Use Letters of Credit in Financing the Sale of Goods*, 20 BUS. LAW. 495 (1965). According to Harfield there is good evidence that the Igibi Bank of Babylon issued letters of credit in 575 B.C. WARD & HARFIELD, *supra* note 8, at 146.

47. WARD & HARFIELD, *supra* note 8, at 146.

by American banks.⁴⁸

There is no identifiable origin of the standby letter of credit in international business transactions. It saw particularly rapid growth as an important domestic financing device during the tight money market of the mid-1960's.⁴⁹ At that time bankers were willing to extend letters of credit when they did not have the funds to extend loans which would serve the same purpose. By extending letters of credit, banks could confer upon their customers the benefits of the bank's reputation without affecting scarce reserve funds. In the international sphere, however, the standby letter of credit apparently developed gradually as the United States increased its involvement in international business transactions.

D. The Issuance of Standby Credits as Incidental to the Business of Banking

The law of letters of credit did not progress with their use. Both the traditional letter of credit and several decades later the standby followed the same pattern: each became a well-established commercial practice before lawyers were called upon to devise a theory to sustain their legality. By the 1940's for the traditional letter of credit, and by the 1970's for the standby, these financial tools had become too valuable commercially to abandon in the face of legal obstacles.

The principal legal obstacle facing traditional and standby letters of credit is that banks have no express authority to issue them. Banks, as statutory creations, have only the powers delegated to them by statute and those incidental thereto.⁵⁰ The question, therefore, is whether the issuance of letters of credit is an incident to the business of banking.

There are basically two approaches to interpreting the scope of powers of national banks as described in the National Bank Act: the broad view and the narrow view.⁵¹ The broad view focuses on Section 21 of the Act. The National Bank Act in 12 U.S.C. § 21 (1976) provides that national banks are created for the purpose of "carrying on the business of banking." The broad approach maintains that banks may thus do anything which is appropriate to the business of banking.⁵² A landmark case⁵³ exemplifying this viewpoint states that the

48. Verkuil, *supra* note 1, at 716-17. They were apparently brought to the U.S. from England and have been used since the inception of U.S. trade. H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 158 (5th ed. 1974) [hereinafter cited as HARFIELD].

49. Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market*, 22 *BUS. LAW.* 1105 (1967).

50. *See Texas & Pac. Ry. v. Pottorff*, 291 U.S. 245, 253 (1934), *modified* 291 U.S. 649 (1934).

51. *See generally* Huck, *What is the Banking Business?*, 21 *BUS. LAW.* 537 (1966).

52. The danger of this approach is that it could lead to unlimited extensions of the

legislature intended to create an extremely broad statute because legislators realized that they could not foresee what customs and usages would develop in the banking business over a long period of time: "These customs vary with times and localities, and hence these incidental powers could not be enumerated but are left to time and circumstance."⁵⁴

On the contrary, the narrow approach maintains that the powers of national banks are limited to those functions which are necessary to carrying out the particular activities enumerated in federal statutes as being the business of banking. Whereas advocates of the broad view emphasize Section 21 of the National Bank Act, proponents of the narrow view focus on 12 U.S.C. § 24(7) (1976).⁵⁵ This paragraph lists specific powers granted to national banks. Those who adopt the narrow view claim that Congress would not have enumerated powers had it not intended to limit the scope of powers of national banks.⁵⁶

Early banks, businessmen, and courts did not question the propriety of bank issuance of letters of credit.⁵⁷ Letters of credit had been issued by merchants since 1800 and by banks since the 1850's.⁵⁸ As letters of credit were useful to businessmen and bankers, it was assumed that authority to issue letters of credit was incidental to the business of banking.⁵⁹

In a later era, after the country had been through the Depression, doubts surfaced as to whether banks could legally issue letters of credit. In the late 1940's the Comptroller of the Currency made an inquiry

business of banking. Proponents of this approach have claimed that it is proper for banks to go into the business of operating a mutual investment fund. *Investment Co. Institute v. Camp*, 401 U.S. 617 (1971); to engage in the travel agency business, *Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972); and to lease motor vehicles, *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 391 F. Supp. 1290 (W.D. Wash 1975), *cert. denied*, 436 U.S. 956 (1978). These efforts have been unsuccessful except that *M & M Leasing Corp.* does not authorize banks to enter leasing agreements which closely resemble loan agreements.

53. *Curtis v. Leavitt*, 15 N.Y. 9 (1857).

54. *Id.* at 169.

55. The "incidental powers" clause of the Act grants national banks power:

[t]o exercise by [their] board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money or personal security; and by obtaining, issuing and circulating notes according to the provisions of this chapter.

12 U.S.C. § 24(7) (1976).

56. *See generally*, Huck, *What is the Banking Business?*, 21 BUS. LAW. 537 (1966).

57. WARD & HARFIELD, *supra* note 8, at 148.

58. *Id.* at 147-48.

59. *See, e.g.*, *Block v. Penn. Exchange Bank*, 253 N.Y. 227, 170 N.E. 900 (1930) for a more recent version of the tradition of the inherent power of banks: "Whatever is an appropriate and usual incident to this substitution or exchange of credits, instead of being foreign to the functions and activities of banking, is in truth of their very essence. It is the end for which a bank exists." 253 N.Y. at 231, 170 N.E. at 901.

into the intrinsic power of national banks to issue traditional letters of credit, focusing on the scope of the implied powers of national banks.⁶⁰ In 1948 the leading authorities on banking law responded to the Comptroller's inquiry by stating that the Federal Reserve Act of 1913, by implication, conferred upon national banks the powers to issue letters of credit.⁶¹ That is, issuance of letters of credit was considered incidental to the specific powers granted to national banks in the Federal Reserve Act.⁶² The problem with this conclusion was that it restricted the use of letters of credit to the types of acceptances authorized by the Federal Reserve Act⁶³ and seemed to ignore the use of letters of credit before 1913. Such a restrictive interpretation of implied powers has gradually given way to the general belief that banks have had the power to issue letters of credit since the National Bank Act of 1864.⁶⁴

The legislative history of the National Bank Act of 1864 indicates that national banks were granted all powers that the New York Banking Act of 1838, the statute on which the national act was based,⁶⁵ conferred upon New York banks. The New York Banking Act of 1838 granted New York banks all powers necessary and appropriate to carrying on the banking business. New York banks issued letters of credit pursuant to that act. Thus, given the broad meaning which has been attached to the word "necessary" in other contexts,⁶⁶ and given the historical fact that New York courts considered the issuance of letters of credit necessary and appropriate to the banking business, it was assumed that national banks had power to issue them.

Standby letters of credit can also be considered as incidental to the business of banking, even within the narrow approach to the scope of powers of national banks. Banks are authorized to make loans.

60. Trimble, *supra* note 41, at 714.

61. *Id.*

62. Article 1, Section 13, paragraph 5 of the Federal Reserve Act authorized member banks to accept drafts or bills of exchange drawn upon them if the validity of such bills or drafts is limited to six months and if they grew out of import-export and certain domestic transactions. Ch. 6, § 13, 38 Stat. 251 (1913).

63. "This pedantically narrow construction impeded the utilization of the acceptance and of the letter of credit." HARFIELD, *supra* note 48, at 158.

64. Trimble, *supra* note 41, at 716.

65. *Id.* at 716-17.

66. *See, e.g.,* McCulloch v. Md., 17 U.S. (4 Wheat.) 316 (1819):

Is it true, that this is the sense in which the word "necessary" is always used? Does it always import an absolute physical necessity, so strong, that one thing, to which another may be termed necessary, cannot exist without that other? We think it does not. If reference be had to its use, in the common affairs of the world . . . we find that it frequently imports no more than that one thing is convenient, or useful, or essential to another. To employ the means necessary to an end, is generally understood as employing any means calculated to produce the end, and not as being confined to those single means, without which the end would be entirely unattainable.

Id. at 413-14.

Standby credits can be described as incidental to that power. Since the standby is a loan which remains contingent until drawn upon, it can be considered a credit incidental to loans.⁶⁷

E. Primary Obligation of Issuer Versus Secondary Obligation of Guarantor

A landmark case for the issue of the legality of letters of credit was decided in 1922. *Border National Bank v. American National Bank*⁶⁸ held that letters of credit are binding legal obligations. The case created a test to distinguish between *intra vires* letters of credit and *ultra vires* guaranties. The test has come to be known as the primary-secondary obligation test and to be widely accepted as the *sine qua non* of letters of credit, traditional and standby.⁶⁹ According to the *Border* doctrine, the issuer of a letter of credit has a primary obligation to pay the beneficiary when the latter presents documents which comply with the requirements of the letter of credit. By contrast, the surety or guarantor has a secondary obligation: the surety is liable under the contract of surety only if the principal defaults and even upon default the surety reserves any defenses that would have been available to the principal.⁷⁰ Standby credits may be written so as to require a notice of default to be among the documents presented before the bank must honor a draft.⁷¹ In that situation, the letter of credit is a secondary means of payment—a promise by the bank to pay the beneficiary should the first agreed-upon means prove inadequate, but the issuer's obligation remains primary. The essential characteristic of a valid letter of credit is that the issuer have a direct obligation to the beneficiary when the latter presents proper documents.

Confusion arises when attempts are made to characterize the primary-secondary obligation test. It has been called both a "formal"⁷² and a "functional" distinction.⁷³ Characterizing it as a "formal" distinction does not mean that the letter of credit must be in any particular

67. See WARD & HARFIELD, *supra* note 8, at 140.

68. 282 F. 73 (5th Cir. 1922), *cert. denied*, 260 U.S. 701, 732 (1922).

69. See *Asociación de Azucareros de Guatemala v. U.S. Nat'l Bank of Oregon*, 423 F.2d 638 (9th Cir. 1970); *American Empire Ins. Co. v. Hanover Nat'l Bank*, 409 F. Supp. 459 (M.D. Pa. 1976); *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1224 (5th Cir. 1973); *Prudential Ins. Co. of Am. v. Marquette Nat'l Bank*, 419 F. Supp. 734 (D. Minn. 1976). Not everyone believes a distinction is made by this test. See, e.g., Sayre, *Clean Letters of Credit*, 56 J. COM. BANK LENDING 56, 58 (1973).

70. See generally L. SIMPSON, *HANDBOOK OF THE LAW OF SURETYSHIP* § 6 at 10 (1950).

71. See U.C.C. § 5-103(1)(b) (1972 version): "'Document' means any paper including document of title, security, invoice, certificate, notice of default and the like."

72. Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market*, 22 BUS. LAW. 1105, 1107 (1967).

73. HARFIELD, *supra* note 48, at 165-66.

form to create a primary obligation. There are no requirements as to the form of a letter of credit.⁷⁴ Characterizing the distinction as functional does not mean that the letter of credit must serve a particular function. Most letters of credit serve the function (*i.e.*, purpose) of a guaranty. Both characterizations refer to the obligation that the letter of credit imposes upon the bank. Its form, that is, the way it is drafted, must create a primary obligation in the issuer; the instrument must require payment upon the presentation of complying documents. Its functioning, or the manner in which it works, is triggered upon presentation of complying documents.

The primary-secondary obligation test has given rise to variant tests, one of which is the documents-performance test. The documents-performance test⁷⁵ states that the issuer of a standby letter of credit is required only to ascertain that the beneficiary has presented documents that comply on their face and not that its customer has performed the underlying contract. In contrast, the surety must examine its customer's performance. The surety looks to the underlying contract to see if the obligations of the contract were performed. The surety has a duty to investigate to see if the beneficiary of the surety contract has actually earned his money.

Another variant test—*independence of and dependence upon the underlying contract*⁷⁶—is simply a restatement of the documents-performance test. It does, however, come closer to suggesting why a distinction should be maintained between standby letters of credit and guaranties. If the instrument in litigation is a letter of credit, evidence of the nonperformance of the underlying contract is immaterial and inadmissible.⁷⁷ Since bankers' basic function is to finance, the implied powers of banks could not be stretched to include participation in their customers' business transactions. A bank's obligation must therefore be that described in the letter of credit and not that indicated in the underlying contract to which the bank is not a party.⁷⁸ If bankers were

74. *Border Nat'l Bank v. Am. Nat'l Bank of San Francisco*, 282 F. at 79; U.C.C. §5-104(1) (1972 version): "Except as otherwise required in subsection (1)(c) of Section 5-102 on scope, no particular form of phrasing is required for a credit. A credit must be in writing and signed by the issuer. . ."; U.C.C. § 5-102(1)(c): "This Article applies . . . (c) to a credit issued by a bank or other person if the credit is not within subparagraphs (a) or (b) but conspicuously states that it is a letter of credit or is conspicuously so entitled."

75. *See, e.g., Courtaulds N. Am., Inc. v. North American Nat'l Bank*, 387 F. Supp. 92, 98-99 (M.D.N.C., 1975), *rev'd*, 528 F.2d 802 (1975); *Pan-American Bank & Trust Co. v. Nat'l City Bank*, 6 F.2d 762, 771 (2d Cir. 1925), *cert. denied*, 269 U.S. 554 (1925).

76. *See, e.g., Prudential Ins. Co. of Am. v. Marquette Nat'l Bank of Minneapolis*, 419 F. Supp. 734, 736 (D. Minn. 1976).

77. *Second Nat'l Bank of Hoboken v. Columbia Trust Co.*, 288 F. 17 (3rd Cir. 1923); *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 173 Conn. 492, 378 A.2d 562 (1977).

78. WARD & HAREFIELD, *supra* note 8, at 20.

required to do more than ascertain the compliance of the beneficiary's documents with the letter of credit, the cost of issuance might be prohibitively high so that the letter of credit would lose one of its principal advantages, its low cost.⁷⁹ Risk also might be increased. As long as the bank's obligation remains exclusively the obligation described in the letter of credit it can quickly and accurately evaluate the risk it undertakes in issuing a letter of credit.⁸⁰ As one scholar has written,

Inasmuch as the issuer of a letter of credit does not legally "guarantee" the payment of a debt owed by a third person, all of the intricacies of the law of suretyship are avoided while, at the same time, the beneficiary of the letter of credit has all of the economic advantages of having the buyer's credit "guaranteed" by a bank.⁸¹

The drafter, therefore, should avoid "guarantee" language by wording the letter of credit so as to create a direct obligation on the part of the issuer to the beneficiary. The beneficiary will then have independent primary obligations from both the issuer and the issuer's customer. If the letter of credit is well-drafted the beneficiary runs little risk of non-payment because a court found his alleged standby letter of credit to be an *ultra vires* guaranty.

III. UNCERTAINTIES AND INCONSISTENCIES IN THE TREATMENT OF STANDBY LETTERS OF CREDIT

A. *In General*

The fact that standby letters of credit are valuable, legal instruments conditioned only upon the compliance of documents presented by the beneficiary does not answer all of the questions that arise concerning them. There is still no consensus as to what role equity should play in this area of law,⁸² no established treatment of the *ultra vires* doctrine and other bank defenses in letter of credit law,⁸³ no unequivocal test for distinguishing between guaranties and standby letters of

79. *Id.* at 37-39.

80. *Id.* at 134.

81. Murray, *Letters of Credit in Nonsale of Goods Transactions*, 30 BUS. LAW. 1103 (1974-75).

82. The principal issue is whether standby letters of credit should be enforced strictly according to their own language even if inequities result from such a construction or whether courts should be able to use their powers of equity to rewrite them, even though such an exercise of judicial discretion would undermine the commercial utility of standby letters of credit by undermining their predictability. See discussion in Subsection B *infra*.

83. The issue is whether banks should be allowed to disclaim liability under an alleged standby letter of credit by claiming that the instrument was in reality a guarantee and that the issuance of guaranties is *ultra vires* the powers of U.S. commercial banks. See discussion in Subsection C *infra*.

credit,⁸⁴ and no clear answer as to the threat standby letters of credit pose to bank solvency.⁸⁵

The result of uncertainty in the law and practice of standby letters of credit is that banks have often felt free to dishonor them in marginal cases and that courts have felt free to evaluate standby letter of credit cases in light of their own attitudes toward banking and financing instruments. The uncertainty is thus compounded; because this is an unsettled area of law, bankers have had leeway to undermine the commercial utility of this valuable financing tool by undercutting its reliability with inconsistent practices that are subsequently sanctioned by inconsistent court rulings.

B. *The Role of Equity*

The role of equity in letter of credit law has been an unsettled issue since *Sztejn v. Schroder Banking Corp.*,⁸⁶ a 1941 New York letter of credit case dealing with a traditional international sale of goods transaction. It was not the holding in *Sztejn* that has led to confusion but the way in which the case has been applied.

When plaintiff purchaser in *Sztejn* learned that the seller beneficiary had shipped worthless materials and had falsified the bills of lading, he moved for an injunction to prohibit the bank from paying on the letter of credit.⁸⁷ The defendant maintained there was no cause of action because a bank issuing a letter of credit can be concerned only with documents, and all documents were in compliance with the terms of the letter of credit.⁸⁸ The court had to decide whether to strictly construe letter of credit law and uphold the instrument because of documentary compliance or to consider the documents as fraudulent and constituting breach of the underlying contract. Justice Shientag denied the bank's motion to dismiss the complaint.⁸⁹ He was careful to state, however, that the injunction was proper not because there was a breach in the underlying contract but because the documents did not, in reality, comply.⁹⁰ The injunction was held proper only because the seller

84. The principal test used for distinguishing between guaranties and standby letters of credit is the primary obligation test (discussed in Subsection D *infra*) articulated in *Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73 (5th Cir. 1922), *cert. denied*, 260 U.S. 701, 732 (1922). Although this test is widely accepted, it is not a definitive solution because it can be applied in different ways to the same fact situation. See the inconsistent application of the test by the Texas Court of Civil Appeals and the Supreme Court of Texas in *Republic Nat'l Bank*, discussed in text accompanying notes 159-69 *infra*.

85. See discussion in Subsection E *infra*.

86. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

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

88. *Id.*

89. *Id.* at 723, 31 N.Y.S.2d at 635.

90. *Id.*

had committed fraud intentionally⁹¹ and because “[n]o hardship would be caused by permitting the bank to refuse payment.”⁹² The court stressed the narrowness of its holding and the importance of maintaining the dependability of the letter of credit:

One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a *most* unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.⁹³

The narrow holding of this decision was no innovation to letter of credit law. As one scholar has stated in his analysis of the opinion, “Of crucial importance . . . is that Justice Shientag invented no novel concepts, but rather affirmed, after scholarly review, the judicial endorsement of commercial practice. Indeed, his opinion should be read as a limitation on judicial interference with the performance of a letter of credit.”⁹⁴ The actual effect of the decision, however, was to contribute to the decline of the reliability of standby letters of credit⁹⁵ by serving

91. *Id.* at 722, 31 N.Y.S.2d at 634.

92. *Id.* at 723, 31 N.Y.S.2d at 635.

93. *Id.* at 633. This holding was incorporated into letter of credit law as § 5-114 of the U.C.C., although the two are not completely congruous. *Sztejn* stands for the proposition that a document which falsifies the facts it purports to evidence is a noncomplying document. Section 5-114, however, maintains that an injunction may be issued even though documents accurately reflect the facts they purport to reflect, if there is fraud in the transaction. See *Enjoining*, *supra* note 16, at 599 n.10.

In a case decided the following year, Justice Shientag made clear that the *Sztejn* rule allowing injunction of the payment against a letter of credit applies only in the rare cases where common law fraud is shown:

[a] notice given by correspondent bank to the issuing bank to the effect that the former was defrauded by either the buyer, the seller or both, is ineffective to void or suspend the operation of the letter of credit. Any other rule would destroy the effectiveness of this valuable commercial device. The common law fraud action is one of the most difficult to prove. . . . This court cannot impose any condition which is not contained in the letter of credit.

Asbury Park & Ocean Grove Bank v. Nat'l City Bank, 35 N.Y.S.2d 985, 989 (Sup. Ct. 1942), *aff'd mem.*, 268 A.D.2d 984, 52 N.Y.S.2d 583 (1944), *appeal denied*, 269 A.D.2d 656, 53 N.Y.S.2d 458 (1945), 294 N.Y. 639 (1945).

94. *Enjoining*, *supra* note 16, at 603.

95. Berman & Kaufman, *The Law of International Commercial Transactions*, 19 HARV. INT'L L.J. 221 (1978):

In recent years, the existence of the injunction against honor for fraud has created a certain erosion of the doctrine of the total independence of the letter of credit contract. In *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank* [356 F. Supp. 991 (N.D. Ga. 1973)], the “fraud” of the Government of India for which the court enjoined the bank was actually a dispute over the effect of *force majeure* on non-performance of the underlying sales contract by the seller. In some cases, courts have issued injunctions against honor where the “fraud” consisted merely of

as a precedent for judges who desire to impose their own considerations of equity in letter of credit cases. Courts refusing enforcement of standby letters of credit have relied on *Sztejn's* reasoning. Scholars have recognized the dichotomy of the effect and the true nature of the case: "The fact that [the decision in *Sztejn*] has been perceived as a significant departure from preexisting law is less than complimentary to the Bench and Bar and has unquestionably had an adverse effect on the utility of standby letters of credit."⁹⁶ The effect is "adverse" because parties cannot depend upon a contract whose enforceability depends upon individual judges' conception of equity.⁹⁷ The marketplace demands reliability.

The damaging effect of equitable considerations to standby letter of credit law and practice was predicted by one scholar at the beginning of this decade.⁹⁸ He called this process "conceptual pollution."⁹⁹ Conceptual pollution takes place when courts look beyond the legal and commercial setting of a case to consider what is equitable.¹⁰⁰ The utility of the standby letter of credit depends upon the close adherence to the law of commercial documentary letters of credit. When courts allow compassion to influence their decisions, the law and practice of standby credits lose all semblance of reliability.¹⁰¹ According to this way of thinking, a result in a particular case is less important than continued validity of this financial instrument.¹⁰² The central message in the discussion of conceptual pollution seems to be that literal compliance with the terms of the letter of credit is the foundation of letter of

the seller's failure to disclose to the buyer his divergent opinion of the nature of his contractual rights.

Id. at 252.

96. *Enjoining, supra* note 16, at 604.

97. Another writer recognized the same characteristics of *Sztejn* but took a much different attitude, realizing that banks as well as individuals might find themselves in a position of wanting to get out of a valid letter of credit contract because of extraneous problems. He entitled his note "Sztejning the Letter of Credit: More Strings for the Bow" and suggested it is a victory for bankers to be able to dishonor unprofitable letters of credit. He recommended that bank counsel be aware of all possible defenses available to the bank against any letter of credit that has been improvidently issued. That is, there is no concern for the integrity of the instrument or the credibility of the bank. Counsel's Corner, 93 *BANKING L.J.* 954 (1976).

98. Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 *U.C.C. L.J.* 7, 8 (1971) [hereinafter cited as *Code, Customs and Conscience*].

99. *Id.* at 9. From a point of view considering human nature rather than business conditions, it is also foreseeable that litigation surrounding the standby letter of credit would increase. The standby letter of credit is often procured in situations where the customer's ability to pay is called into question. Thus it is more probable than in other situations that the customer will default and that the issuer will be looking for a way to free itself from its obligation. Given the lack of precise legal requirements of the letter of credit, the issuer is free to be creative in devising defenses. See Justice, note 3 *supra*, at 431.

100. *Code, Customs and Conscience, supra* note 98, at 11.

101. *Id.* at 14.

102. *Id.* at 15.

credit law, a notion which derives from the necessities of the marketplace.¹⁰³

Cases subsequent to *Sztejn* have exemplified the erosive effect against which Justice Shientag warned. *Wichita Eagle and Beacon Publishing Company v. Pacific National Bank of San Francisco*¹⁰⁴ and *Fair Pavilions, Inc. v. First National City Bank*¹⁰⁵ are two well-known contributors to the confusion concerning the role of equity and consequently the absoluteness of a bank's obligation to honor its standby letters of credit. Both cases are standby letters of credit cases, one dealing with a guaranty of performance and the other with a guaranty of payment. Each case tends to undermine the reliability of standby letters of credit by its consideration of equity.

In *Wichita Eagle*, the defendant bank issued a standby letter of credit to guarantee its customer's commitment to build a parking garage on land leased from plaintiff.¹⁰⁶ The letter of credit provided that it would terminate upon the city's denial of a building permit for the garage.¹⁰⁷ When the customer confronted financing difficulties and realized the construction of the garage would be unprofitable, he submitted an untrue statement to the bank that the credit must be terminated because the city had refused to issue a building permit.¹⁰⁸ When the bank's customer failed to build the garage and plaintiff drew against the letter of credit, the bank refused to honor the draft, claiming that the instrument had terminated.¹⁰⁹ The bank had accepted its customer's false representation and terminated its obligation in accordance with the provisions of the letter of credit. The district court, however, did not approve the bank's action. It held that the letter of credit was still in effect even though the customer had submitted the documents required to terminate it:

The bare letter from Circular Ramp [submitted by the customer stating that the city had refused to issue a building permit], without any accompanying documentation or other proof, cannot be held sufficient to have terminated the letter of credit. . . . [T]he Bank could have easily ascertained whether the City of Wichita had refused to issue a building permit.¹¹⁰

103. *Id.* at 9.

104. 343 F. Supp. 332 (N.D. Cal. 1971), *rev'd*, 493 F.2d 1285 (9th Cir. 1974).

105. 24 A.D.2d 109, 264 N.Y.S.2d 255 (1965), *rev'd*, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).

106. 343 F. Supp. at 343.

107. *Id.* at 342-43.

108. *Id.* at 335-36.

109. *Id.* at 337.

110. *Id.* at 339-40.

The bank was thus required to go beyond the documents, to do more than ascertain whether they were valid on their face. The court thus contradicted both statutory law and commercial practice.

The court of appeals reversed the decision of the district court, holding that the instrument was not a letter of credit but a guaranty because the conditions for payment were extremely complex and not independent of the underlying contract.¹¹¹ Because of the instrument's language, the bank was required to ascertain facts rather than solely to examine documents. Even though the document was determined to be an *ultra vires* guaranty, the court did not excuse the bank's contractual obligation.

Neither the holding of the district court nor that of the court of appeals seems satisfactory. The district court erred by requiring more from a letter of credit than a letter of credit is designed to offer. The letter of credit is designed to balance the risk of transactions between parties who deal with each other over long distances and who often do not know each other.¹¹² For the beneficiary it adds the promise of a party of known solvency to the promise of the customer whose financial position may not be obvious. For the customer it provides an inexpensive means of reserving money for a particular transaction. The letter of credit is not designed to protect parties from untrue statements of other parties. A corporate surety has investigative resources and legal power to protect its customer from the dishonesty of other parties to a surety contract; its function is to assure that underlying promises are performed adequately. A bank does not have such resources and power to protect its customers in letter of credit contracts. Its only concern is documentary compliance.

The court of appeals' solution also seems unsatisfactory because it fails to recognize the nature and limitations of a letter of credit. By refusing to recognize an instrument that all parties intended to be a valid standby letter of credit and one that arguably created a primary obligation on the part of the issuer, the court of appeals has undermined the credibility of standby letters of credit in general. The court went too far in protecting an innocent party. The beneficiary could have protected himself in this case by requiring a more carefully drafted letter of credit. The beneficiary could have required as documents the certificate of a third party, perhaps an official refusal of a building permit from the city.

111. 493 F.2d 1285, 1286 (9th Cir. 1974). According to Harfield, "The credit was drafted so that it looked like a misalliance between a surety bond and the engineering specifications in a construction contract." Harfield, *The Standby Letter of Credit Debate*, 94 BANKING L.J. 293, 294 (1977) [hereinafter cited as *S.L.C. Debate*].

112. KOZOLCHYK, *supra* note 45, at 11-12.

In *Fair Pavilions*, the fact situation is analogous to that of *Wichita Eagle*. Plaintiff Fair Pavilions, Inc. entered into a contract with Exhibitions de France to construct a building at the World's Fair. Exhibitions was required to furnish plaintiff an irrevocable letter of credit drawn upon a New York bank, guaranteeing some of the installment payments. Exhibitions arranged with Willard International Financing Company, Ltd. to have a letter of credit issued. At Willard's request, First National City Bank issued an irrevocable letter of credit with plaintiff as beneficiary.¹¹³ In the same manner as the letter of credit in *Wichita Eagle*, this letter was tied by its own language to the underlying contract. It provided that if the bank received an affidavit from Willard reporting the occurrence of one or more of the events listed, the owner would have the right to terminate the underlying contract, and the letter of credit would be terminated. Before the last payment was to be paid, the bank received an affidavit from Willard stating simply that, "One or more of the events described in Clause XV [of the underlying contract] . . . have occurred."¹¹⁴ The Appellate Division, recognizing the doctrine of strict compliance and the independence of the letter of credit contract, held that the bank was not obliged to assume the burden of determining the accuracy of the representation.¹¹⁵ The Court of Appeals, however, in effect, rewrote the letter of credit by requiring more than strict compliance:

[I]n our view, plaintiff is entitled to summary judgment for the reason that the affidavit . . . ostensibly delivered to defendant under paragraph 6 of the letter of credit, failed to state what event among those enumerated in clause XV of the building contract was claimed to have occurred, on account of which it was declared that the bank's obligation under the letter of credit was terminated. The documents before the bank were, therefore, insufficient on their face to justify refusal to pay on the letter of credit.¹¹⁶

Rather than looking to the letter of credit to determine the bank's obligation, the court required the bank to withhold payment because of Willard's motivation: Willard issued the affidavit because both Willard and Exhibitions had become insolvent.¹¹⁷ The court claimed the documents were insufficient on their face because they would not be sufficient to identify the problem to the plaintiff so that it could correct it.¹¹⁸

113. 19 N.Y.2d at 515, 227 N.E.2d at 840, 281 N.Y.S.2d at 24.

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

115. 24 A.D.2d at 112, 264 N.Y.S.2d at 258-59.

116. 19 N.Y.2d at 516, 227 N.E.2d at 840, 281 N.Y.S.2d at 25.

117. *Id.*

118. *Id.* at 517, 227 N.E.2d at 841, 281 N.Y.S.2d at 27.

The real reason, however, appears at the end of the opinion and is based on the court's consideration of equity: "Paragraph 6 of the letter of credit is a drastic provision which, as so construed, would place one party at the mercy of another."¹¹⁹

The opinions in *Wichita Eagle* and *Fair Pavilions* reveal the independent thinking in which judges feel free to indulge when working in an area lacking settled law. They do not feel compelled to observe limitations inherent in the standby letter of credit. The standby is a "blunt instrument."¹²⁰ It is designed to be a quick, sure method of payment or security device. Because of its role in international transactions it is essential that the standby work without delays. If a foreign beneficiary is forced to return to the jurisdiction of the issuer to try to enforce his rights, the letter of credit has failed to serve its purpose. But a standby letter of credit is not designed to protect parties from problems in the performance of other contracts. It cannot protect parties from this kind of risk, and when courts take advantage of legal uncertainties to allow it to do so, they create uncertainty in issuers' obligations and in beneficiaries' rights. In the long run it seems preferable to create certainty in the law and practice of standby letters of credit so that parties will know better how to protect themselves than to produce equitable results on a case-by-case basis.¹²¹

C. Banks Abdicating Obligations Under Standby Letters of Credit

As stated above, banks have felt free and have sometimes succeeded in claiming defenses to extricate themselves from undesirable standby credits. They have been able to do so because of the equivocality which still surrounds the law of standby letters of credit. For an example of uncertainty in an important area, consider J. Morse's treatment of the *ultra vires* defense and the total inconsistency of that view with two widely accepted 1976 cases. In his treatise, Morse uses the same reasoning that led to the demise of the *ultra vires* defense in the law of corporations.¹²² Morse states that an *ultra vires* defense is always unacceptable because it is fundamentally unfair:

It would be a lamentable state of law in which a court would allow a defendant to say, "I exceeded my power, and, as the law will not recognize any transaction that involves its own violation, you cannot recover." The law will recognize its own violation to punish it, and compel justice, and prevent a

119. *Id.* at 517, 227 N.E.2d at 842, 281 N.Y.S.2d at 27.

120. Battaille, *supra* note 42, at 830.

121. See *Code, Customs and Conscience*, *supra* note 98, at 15.

122. See generally HENN, CORPORATIONS § 184 (2nd ed. 1970); TEX. BUS. CORP. ACT. ANN. art. 204 (Vernon 1956).

wrongdoer from taking advantage of his own wrong.¹²³

In both *New Jersey Bank v. Palladino*¹²⁴ and *International Dairy Queen v. Bank of Wadley*,¹²⁵ banks were allowed to escape their obligations under standby letters of credit by claiming they had violated the law. These and similar cases thus preserve the defense of *ultra vires* to nullify standby letters of credit whereas *ultra vires* is a dying doctrine in virtually all areas of corporate law. The *Palladino* court concluded that because the bank had violated the New Jersey statute which denies banks the power to guarantee the obligations of others, the contract would not be upheld. The court was apparently oblivious to the great confusion concerning distinctions between standby letters of credit and guaranties¹²⁶ when it stated that the plaintiff "knew, or should have known, that the offer of defendant bank to guarantee the Palladino account was illegal and void."¹²⁷ In *International Dairy Queen* the alleged letter of credit was held to be void because in issuing it, the bank had exceeded its loan limit: "violation of a regulatory statute intended for the benefit of the public renders a contract void and unenforceable."¹²⁸

Banks have not restricted their claims to the *ultra vires* defense. Since *Fair Pavilions* and *Wichita Eagle* it has become a common practice for issuing banks to claim a technical defense in order to refuse to honor a standby letter of credit when they believe they will be unable to recover from their customer. They have received different responses from the courts, depending partly upon their ingenuity in devising these defenses. In *Brummer v. Bankers Trust of South Carolina*¹²⁹ the bank was obviously grasping for any possible way out of its obligation when it defended that the instrument was a standby letter of credit, as if such an instrument obviously were illegal, and that there was a change in the underlying contract, as if a letter of credit obligation were dependent upon the underlying performance contract.¹³⁰ Both claims reveal a total misconception of the nature of the instrument. In *Prudential Ins. Co. v. Marquette National Bank*¹³¹ the bank claimed not only that its alleged letter of credit was an *ultra vires* guaranty, but also that it was

123. 2 J. MORSE, A TREATISE ON THE LAW OF BANKS AND BANKING 1488 (6th ed. 1928).

124. 146 N.J. Super. 6, 368 A.2d 943 (App. Div. 1976), *cert. denied*, 73 N.J. 64, 372 A.2d 329 (1977).

125. 407 F. Supp. 1270 (M.D. Ala. 1976).

126. For discussion distinguishing between standby letters of credit and guaranties see Section II(D) *infra*.

127. 146 N.J. Super. at 14, 368 A.2d at 946.

128. 407 F. Supp. at 1272.

129. 261 S.C. 21, 231 S.E.2d 298 (1977).

130. *Id.* at 22, 231 S.E.2d at 299.

131. 419 F. Supp. 734 (D. Minn. 1976).

an illegal penalty provision.¹³²

In his study of standby letters of credit, P. Verkuil sees banks as the culprit in the declining certainty in letter of credit practices and consequent declining public confidence in standby letters of credit:

Current litigation over guaranty letters of credit has created a risk for the banking industry. . . . The banking community has fought hard in the past to defend the sanctity of 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.¹³³

The courts, it seems, must share this culpability. Banks have been encouraged to litigate their obligations because the courts often have permitted banks to free themselves from undesirable contracts. If case law for standby letters of credit were as certain as that for traditional letters of credit, banks would have no incentive to deny their obligations. They would know that standby credit obligations are binding.

Wichita Eagle & Beacon Publishing Company v. Pacific National Bank of San Francisco,¹³⁴ *Fair Pavilions, Inc. v. First National City Bank*,¹³⁵ *Brummer v. Bankers Trust of South Carolina*,¹³⁶ *Prudential Ins. Co. v. Marquette National Bank*,¹³⁷ and numerous other cases cited in this note have contributed to this trend of nonenforcement of standby letters of credit. Even when courts have upheld the integrity of the standby letter of credit, the utility of this instrument has nevertheless been undermined because potential beneficiaries can do nothing but believe that litigation is likely to arise from such a contract.¹³⁸

A solution to the problem concerning bank abdication of obligation is for banks to become aware of the damage caused to their own credibility and to the standby credit. They must be willing to take losses on standby credits as they do in other areas. Courts must encourage this attitude by enforcing standby letter of credit obligations, whenever it was the intention of the parties to create such an obliga-

132. *Id.* at 735. Cf. Comment, *Recent Extensions in the Use of Commercial Letters of Credit*, 66 YALE L.J. 902, 918-19 (1957) (where the author predicted that issuers might successfully claim a penalty defense, given judicial hostility to penalties in contract law).

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

134. 343 F. Supp. 332 (N.D. Cal. 1971), *rev'd*, 493 F.2d 1285 (9th Cir. 1974).

135. 24 A.D.2d 109, 264 N.Y.S.2d 255 (1965), *rev'd*, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).

136. 261 S.C. 21, 231 S.E.2d 298 (1977).

137. 419 F. Supp. 734 (D. Minn. 1976).

138. See Justice, *supra* note 3, for the concept of the sanctity of letters of credit: "Each defense which is recognized by the courts will further erode the absoluteness of the issuer's obligation. Even when an asserted defense is rejected by a court, the mere fact that it has been asserted will shake the foundation on which rests the dependability of letters of credit." *Id.* at 439.

tion, and whenever such an intention can reasonably be found in the document they drafted.

D. Distinguishing Between Guaranties and Standby Letters of Credit

The *ultra vires* doctrine, when it was still a recognized tenet of corporate law, gave rise to the rule that banks do not have the power to lend their credit (as opposed to their money) or to guarantee the obligations of others. Such activities are not incidental to the business of banking. The landmark case in this area is *Bowen v. Needles National Bank*¹³⁹ which held that "no banking corporation has the power to become a guarantor of the obligation of another, or to lend its credit to any person or corporation."¹⁴⁰ Certainly banks do lend their credit when they issue standby letters of credit. This rule is thus inconsistent with the notion that the issuance of standby letters of credit is a legal activity for banks.¹⁴¹ Its application to letter of credit cases results in holding valid standby letters of credit to be void as *ultra vires* guaranties.¹⁴²

In spite of the rule prohibiting bank guaranties, even the most indomitable financial conservatives would not claim that all bank guaranties are illegal. The Comptroller of the Currency provided that a national bank may become a guarantor if it has a substantial interest in the performance of the transaction involved or has a segregated deposit from the guaranteed party sufficient to cover the bank's total potential liability.¹⁴³ The reasoning behind the rule against bank guaranties is that they are a threat to bank solvency.¹⁴⁴ The business of guaranteeing the obligations of others is a risky business because the guarantor assumes the obligations of its principal without having any control over the principal's activities. Guaranteeing requires the guarantor to venture into the business of its principal. It is thus not sound banking because a bank has no expertise in the business of its customers.¹⁴⁵

Since the rule against guaranties is based on concern for bank solvency, courts have sometimes upheld guaranties that pose no such threat. In *FDIC v. Pioneer State Bank*¹⁴⁶ the court upheld a guaranty

139. 94 F. 925 (9th Cir. 1899), *cert. denied*, 176 U.S. 682 (1900).

140. *Id.* at 927.

141. Lord, *The No-Guaranty Rule and the Standby Letter of Credit Controversy*, 96 BANKING L.J. 46, 60-62 (1979).

142. *See, e.g., Republic Nat'l Bank v. Fort Worth Nat'l Bank*, 566 S.W.2d 358 (Tex. Civ. App.—Ft. Worth), *rev'd*, 578 S.W.2d 109 (Tex. 1979). For further discussion of this case see notes 148-68 *infra* and the accompanying text.

143. 12 U.S.C. § 7.7010 (1978).

144. *See, e.g., Bank of N.C., N.A. v. Rock Island Bank*, 570 F.2d 202, 205 (7th Cir. 1978).

145. WARD & HARFIELD, *supra* note 8, at 133-34.

146. 155 N.J. Super. 381, 382 A.2d 958 (1977).

made by a financially distressed bank in connection with its sale to another bank of certain leasing agreements. Because the guaranty tended to diminish rather than increase the bank's risk of loss, the guaranty was enforced.¹⁴⁷

U.C.C. Section 5-113(1) (1972 version) provides for another type of bank guaranty. When a bank seeking payment under a letter of credit meets recalcitrance because the documents it presents fail in some aspect to meet the requirements of the letter of credit, it may give a guaranty to the paying bank promising that it will be responsible should any problems arise from the noncompliance of the documents. Comment 1 to this section identifies such guaranties as "a proper part of the business of banking."

Separate from the problem of which bank guaranties are legal is the problem of what is a guaranty. The label given to a document is irrelevant. In *Republic National Bank v. Fort Worth National Bank*¹⁴⁸ the Texas Court of Civil Appeals declared the letter to be a guaranty even though the instrument was called a letter of credit on its face. In *Pan-American Bank and Trust Co. v. National City Bank of New York*¹⁴⁹ the situation was the converse. The letters and telegrams in question were referred to as guaranties, yet the court upheld them as letters of credit, stating that "it is clear that the legal effect of what men do is not determined by the names they affix to their deeds."¹⁵⁰

Confusion has arisen from the ambiguous usage of the word "guaranty" as it relates to standby letters of credit.¹⁵¹ Often definitions of letters of credit include the noun or verb form of a word "guaranty."¹⁵² Throughout much of the 19th century the terms "letter of credit" and "guaranty" were used interchangeably.¹⁵³ The practice still

147. *Id.* at 384, 382 A.2d at 965.

148. 566 S.W.2d 358 (Tex. Civ. App.—Ft. Worth), *rev'd*, 578 S.W.2d 109 (Tex. 1979).

149. 6 F.2d 762, 769 (2d Cir. 1925).

150. *Id.* at 766.

151. Is it relevant that there is even controversy over the orthography of the word? "Guaranty" as a verb has been superceded by "guarantee" and the latter form should therefore always be used. 4 OXFORD ENGLISH DICTIONARY 477 (1933 ed., reprinted 1970). Practice does not corroborate this rule. See quotes in this paper. The author has used "guaranty" for the noun and "guarantee" for the verb.

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

Harfield, *Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92, 93 (1962) [hereinafter cited as *Code Treatment*].

152. See, e.g., *Second Nat'l Bank of Hoboken v. Columbia Trust Co.*, 288 F. 17, 20 (3rd Cir. 1923); 123 CONG. REC. 513, 866 (1977).

153. Jarvis, *Standby Letters of Credit-Issuers' Subrogation and Assignment Rights—Part I*, 9 U.C.C. L.J. 356, 373 n.72 (1977).

exists. Standby letters of credit are often referred to as "guaranty letters of credit."¹⁵⁴ Sometimes a bank will entitle a certain instrument a "guaranty" yet treat it as a standby credit for purposes of bookkeeping and auditing.¹⁵⁵

Since neither scholars nor judges have been able to establish clearly what constitutes a guaranty, it follows that they have been unable to distinguish clearly between a standby letter of credit and a guaranty. The accepted test for making this distinction, as stated earlier, is the primary-secondary obligation test of *Border National Bank v. American National Bank*.¹⁵⁶ Some scholars find this test the definitive solution to the problem of distinguishing between *ultra vires* guaranties and *intra vires* letters of credit:

In the case of a letter of credit, the obligation of the issuer to the payor is a direct and primary obligation, whether express or implied. On the other hand, a guaranty is a promise guaranteeing the performance of the obligation of one person to another. There is no question but that a letter of credit and a guaranty are mutually exclusive.¹⁵⁷

Distinguishing between a primary and secondary obligation has at times proved to be as difficult as distinguishing between a guaranty and a standby letter of credit. In a recent Texas case¹⁵⁸ the Court of Civil Appeals was called upon to determine the legality of a purported standby letter of credit that was designed to secure a promissory note. In the event the obligor of the promissory note did not meet its payments, the beneficiary of the standby letter of credit was to present a notice of default to the issuer to trigger payment under the letter of credit. In evaluating the nature of the issuer's obligation the court considered the purpose of the letter of credit. The court refused to enforce the letter of credit because it served the purpose of guaranteeing payment of the promissory note. The court reasoned that the obligation could not be primary if its purpose was to guarantee the debt of another:

The face of the instrument discloses that the liability of the Northwest National Bank was to come into existence only in

154. The FDIC used the terms "standby" and "guaranty" letter of credit interchangeably when it proposed legislation for them. 39 Fed. Reg. 2494 (1974).

155. The Bank of Tokyo, Houston, Texas, classifies a "steamer guaranty" as a standby letter of credit. Interview with Partha Council, *supra* note 12. For a discussion of the steamer guaranty, see text accompanying notes 19-20 *supra*.

156. 282 F. 73 (5th Cir. 1922), *cert. denied*, 260 U.S. 701, 732 (1922).

157. Trimble, *The Law Merchant and the Letter of Credit*, 61 HARV. L. REV. 981, 1007 (1948).

158. Republic Nat'l Bank v. Northwest Nat'l Bank, 566 S.W.2d 358 (Tex. Civ. App.—Ft. Worth), *rev'd*, 578 S.W.2d 109 (Tex. 1979).

the event of the default of the [obligor] upon its note. . . . In other words the instrument constituted a guaranty by the bank to the beneficiary that if and in the event the note obligor defaulted upon the obligation the bank would, in the place and stead of the obligor, make the beneficiary whole.¹⁵⁹

The court recognized the primary-secondary obligation test as the proper test for distinguishing between a letter of credit and a guaranty:

Though every letter of credit is, in a sense, a form of guaranty, *the letter of credit differs from a classical surety undertaking in that it is a primary obligation between the issuer and the beneficiary* and the issuer of the credit is not concerned with the arrangements between the beneficiary and the issuer's account party.¹⁶⁰

No explanation was offered as to what would be required to create a primary obligation in this fact situation; the court restricted itself to a discussion of the purpose of the letter of credit. The language of the Court of Appeals is the same as that used subsequently by the Texas Supreme Court to overturn the Court of Appeals' decision.¹⁶¹

Because the Texas Supreme Court reversed the decision, the effects of the Court of Appeals' opinion were not pervasive. They do, however, suggest the possible consequences to the vitality of standby letters of credit which result when banks try to extricate themselves from undesirable letters of credit and courts allow them to do so. Texas banks became more reluctant to issue standby letters of credit and limited issuance of standbys to customers in whose credit they had absolute confidence but were wary to lend them to new customers.¹⁶² Banks were also more hesitant to issue a standby letter of credit when any other method of serving the customer's needs was available.¹⁶³ The case did therefore create obstacles to the further development and use of the standby letter of credit in at least two ways: it made banks more reluctant to issue them and encouraged issuing banks to disavow

159. 566 S.W.2d at 361.

160. *Id.*

161. The Texas Supreme Court stated:

A true guaranty creates a secondary obligation whereby the guarantor promises to answer for the debt of another and may be called upon to perform once the primary obligor has failed to perform. . . . A bank that issues a credit, however, acts as a principal, not as an agent of the account party, and it engages its own credit. . . . Thus, upon the issuance of a credit, the bank assumes a primary obligation independent of the underlying contract and engages that it will pay upon the presentation of documents required by the instrument.

578 S.W.2d at 114. As support, the court cited *Border Nat'l Bank v. Am. Nat'l Bank*, 282 F. 73, 77-78 (5th Cir. 1922), *cert. denied*, 260 U.S. 701, 732 (1922), discussed in Section II(E),

supra.

162. Interview with Lea Resende, *supra* note 12.

163. *Id.*

their liability on standby letters of credit when it became economically disadvantageous to honor them.

Similar to the analysis of the lower courts, the Texas Supreme Court's treatment of the instrument issued by Northwest National Bank offers no definitive explanation as to what are the essential distinctions between a standby letter of credit and a guaranty. Like most courts dealing with standby letters of credit, the Texas Supreme Court was conscious of the scarcity of clear law or precedent in this area. It explicitly declared its freedom to search out relevant law and impliedly to find law palatable to its own inclinations: "Since we have been unable to locate any Texas case law pertinent to this particular question, we will freely consult decisional authority from other jurisdictions in addition to the guidance provided by Chapter 5 of the Texas Business and Commerce Code."¹⁶⁴

The court possibly could have offered a perceptive analysis of why standby letters of credit are not guaranties, or it could have agreed with the lower courts that the instrument was a guaranty but enforced it against the issuer for policy reasons. Instead, it apparently accepted the tradition that there is a difference between a standby credit and a guaranty and offered the conventional explanation as to what constitutes that difference. When the court said, "there are several subtle but important distinctions,"¹⁶⁵ it suggested that it might enter into an elucidating analysis. The court proceeded, however, to present only the reasons of *Border National Bank v. American National Bank*.¹⁶⁶ The rule of the case is simply a restatement of the early primary-secondary obligation test: "The engagement is a letter of credit if the issuer has a *primary* obligation that is dependent solely upon presentation of conforming documents and not upon the factual performance or nonperformance by the parties of the underlying transactions."¹⁶⁷ The court did not deal with the incontrovertible finding of the lower court that the purpose of the contract was to guarantee the performance of the obligor on the promissory note. Although the court did not provide a better analysis of the nature of the standby letter of credit than did the lower courts, it did discuss the relevant law and practice and indicate that it would encourage the use of standby letters of credit by enforcing them whenever the court could reasonably find that purported letters of credit create primary obligations on the issuers. The court thus does

164. 578 S.W.2d at 112.

165. *Id.* at 114.

166. 282 F. 73 (5th Cir. 1922), *cert. denied*, 260 U.S. 701, 732 (1922), discussed in Section II(E), *supra*.

167. 578 S.W.2d at 115 (emphasis in original).

nothing to clarify the legal distinctions between guaranties and standby letters of credit.

The value of the opinion is that it notifies issuers and customers that instruments within the description of letters of credit or standby letters of credit in the U.C.C. and regulations of the banking agencies will be upheld in Texas. Other states may follow Texas' example so that the case's influence will be felt beyond its own jurisdiction. Consequently, banks are notified that they must be careful to comply with the formal requirements of those statutes and that they must take their standby letter of credit obligations seriously since they will not be able to escape merely by claiming an *ultra vires* defense. The community, on the other hand, is notified that the courts will enforce standby letter of credit obligations. Customers can thus theoretically have confidence to use them when such an instrument meets their needs.

A logical conclusion to the distinction between guaranties and standby letters of credit is that no clear line can be drawn between them. The only distinction to be made is one of form—whether the instrument creates a primary or secondary obligation—and that theoretical distinction is not particularly helpful in a practical setting. In order to be effective, the distinction must be accepted as a convention, a formality to be observed rigorously by drafters of standby credits. Bankers, businessmen, and their lawyers must develop phraseology that, by agreement, indisputably creates a primary obligation. It is the "wording" of standby letters of credit which distinguishes them from guaranties.¹⁶⁸

E. Threat of Standby Letters of Credit to Bank Solvency

Standby letters of credit threaten bank solvency in at least three ways. The principal problem is that bankers underestimate the risks of the transaction by assuming standby letters will not be drawn upon.¹⁶⁹ Bankers typically do not obligate themselves in conventional loans without making a credit analysis and without considering security. They often do not make a thorough credit analysis, however, even though the risk created by a standby letter of credit obligation resembles that of an unsecured loan.¹⁷⁰ This state of affairs has been called

168. This clarification was made in an interview with Lea Resende, *supra* note 12.

169. An interoffice memorandum used at First Chicago National Bank informs employees that, "the majority of standby credits at First Chicago expire without ever being drawn down." Part IV, p. 2 of the memorandum. See WARD & HARFIELD, *supra* note 8, at 138.

170. Once standby letters of credit are drawn upon they become loans to the bank customer. If the banker has not contracted for security in a separate agreement with his customer, the standby credit obligation becomes an unsecured loan. See KOZOLCHYK, *supra* note 45, at 622-23. State member banks are required by the Federal Reserve system to subject standby letter of credit applications to a loan analysis:

the "I didn't know it was loaded" syndrome.¹⁷¹ It is a problem which results from poor judgment; it is not a characteristic inherent in the instrument.

The second threat deals with the vulnerability of the bank in case of default of the obligor, its customer. Whereas the issuer of a traditional letter of credit is protected by its control of title documents to the goods shipped by the seller, the issuer of the standby letter of credit has only whatever protection it demands in the contract with its customer. Its obligation often comes into effect only when a customer is in financial trouble. Therefore, by the nature of the transaction, the possibility of recovery from the customer is not good.¹⁷² The bank can protect itself, however, by requiring collateral from its customer in the separate contract between those two parties.

The third threat to bank solvency may be the ultimate cause of the previously mentioned vulnerability. Since standby letters of credit are treated as contingent liabilities not reflected in the issuer's balance sheet, but in a footnote, arguably there is nothing to prevent banks from issuing standby letters of credit in improvident amounts.¹⁷³ Former Senator Edward Brooke urged Congress in 1974 and 1977 to impose stricter regulations to protect bank depositors from the greed of bankers seeking to multiply their money by overextending themselves with standby letters of credit. In 1974 he proposed a bill which would subject standby letters of credit to "traditional bank safeguards" including limitations on aggregate liabilities, legal lending limits, reserve requirements, balance sheet disclosure, and full credit analysis.¹⁷⁴ It was not until 1977 that a modified version of the bill was passed by the Senate.¹⁷⁵ The legislation was not reported out of the House.

No state member bank shall issue a standby letter of credit or ineligible acceptance unless the credit standing of the account party under any letter of credit, and the customer of an ineligible acceptance, is the subject of credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation.

12 C.F.R. § 208.8(d)(ii) (1978).

171. *Code, Customs and Conscience*, *supra* note 98, at 15. See also *S.L.C. Debate*, *supra* note 111, at 296: "One can find case after case . . . in which a banker is called upon to pay under a letter of credit and is absolutely astonished because (he vows) he would never have issued the letter of credit if he had thought that anyone was going to use it."; Battaile, *supra* note 42, at 839 n.113 (1974).

172. The sympathy of some courts toward the *ultra vires* doctrine relates to the issue of bank vulnerability. Whereas bankers concerned with reliability and vitality of the letter of credit see the *ultra vires* defense as an eroding force, some courts might see it as a protection of depositors from bankers' involvement in unsound practices. Certainly the public, one could argue, has an interest in the stability of banks.

173. They are not treated for reserve requirements as a loan until they are drawn upon. They are, however, subject to lending limits. 12 C.F.R. § 71160(b) (1978); 12 C.F.R. § 337.2(b) (1979); 12 C.F.R. § 208.8(d)(2) (1978).

174. 120 CONG. REC. 29,795 (1974).

175. S. 71, 95th Cong., 1st Sess. (1977). Senator Brooke's amendment was appended to major banking reform legislation. A House equivalent, H.R. 13471, was introduced. The

In conjunction with the concern for the effect of standby credits on bank solvency is the concern for public confidence and the confidence of foreign banking institutions in U.S. banks. According to former Senator Brooke, the collapse of three large national banks in the early 1970's, resulting in part from the unwise use of standby letters of credit, has contributed to an undesirable state of affairs in these areas.¹⁷⁶ Public confidence was shaken, and foreign banks reduced their credit lines with American banks by over \$100 million.¹⁷⁷ In a speech to the Senate, Mr. Brooke quoted the general manager of Westminster Bank's international banking division as saying, "The whole question of the validity of letters of credit on United States banks has been thrown into doubt. All foreign banks must seriously review their lending policies to United States banks, especially where letters of credit are involved."¹⁷⁸

This concern may be exaggerated, at least as it relates to standby letters of credit. Former Senator Brooke saw an improvident use of standby letters of credit as a major contributor to the collapse of U.S. National Bank of San Diego.¹⁷⁹ Although it is true that U.S. National Bank had \$100 million of outstanding letters of credit, it is not clear that the collapse was significantly influenced by this use of the bank's money. Congressional and contemporary media reports indicate that the bank collapsed because of the allegedly illegal activities of one of its directors, C. Arnholt Smith.¹⁸⁰

Whereas bankers emphasize the low cost of standby letters of credit as a feature attractive to bank customers, those preoccupied with bank solvency have pointed out that it is an easy, inflationary, and risky means for banks to earn big profits.¹⁸¹ It is both easy and inflationary because banks are not required to commit any funds until a default occurs. As one example of problems resulting from this lack of

House Bill was recognized as being "considerably tougher than the Senate Bill and has the potential to create many time-consuming controversies." CONG. Q., Aug. 29, 1978, p. 2256.

176. 120 CONG. REC. 29,791 (1974).

177. *Id.*

178. *Id.*

179. *Id.*

180. New York Times, June 21, 1974, at 57, col. 4 and July 3, 1974, at 43, col. 1 & 2. A House banking subcommittee investigation of that failure revealed that "massive insider abuses" including \$450 million in loans to C. Arnholt Smith were the bank's nemesis. CONG. Q., Aug. 26, 1978, p. 2256.

In 1973, the S.E.C. and the U.S. Comptroller of the Currency took action against Smith that ultimately resulted in the closing and forced sale of U.S. National Bank of San Diego and the entry into Chapter 10 reorganization proceedings of Westgate-California Corp., both of which Smith had controlled. Smith was removed from management of Westgate and later pleaded no contest to criminal charges of conspiracy and misapplication of funds from the bank. He was fined \$10,000 and placed on probation. Los Angeles Times, Oct. 9, 1978, at III, 16, col. 1.

181. 120 CONG. REC. 29,792 (1974).

requirements, former Senator Brooke offered in 1974 statistics of a bank that had overextended itself in the issuance of standby letters of credit which increased its debt-to-equity ratio to a dangerous level.¹⁸² If a large portion of the letters were suddenly called upon, an event not unlikely in a tight money market, the bank would surely have to call upon the FDIC to rescue it from its unsound practices.¹⁸³

Although some action needs to be taken to minimize the threat caused by standby letters of credit to bank solvency, the most recent attempts at legislation could be characterized as overly rigid, especially the call for reserve requirements. If standby letters of credit were subject to significant reserve requirements, they could not be issued at low cost to the bank and to the customer as they are today.

Those who oppose rigid legislation agree that applications for standby credits should be subjected to the same credit analysis as are loan applications¹⁸⁴ but believe that such analysis should be imposed by the self-discipline of banks¹⁸⁵ and not by federal regulations. They identify past problems as being the result of bankers who failed to exercise sound judgment and not of any dangers inherent in letters of credit.¹⁸⁶ One author opposed to further legislative restrictions on standby letters of credit recommends that banks make an exhaustive study of how to go about credit analysis.¹⁸⁷ The product of this study would be an effective "formula" for credit analysis on standby letter of credit applications. Such a study would result in the benefit of a reliable method for assessing the creditworthiness of bank customers applying for standby letters of credit. Moreover, bank examiners would have concrete criteria on which to evaluate a bank's letter of credit practices.

This proposal seems to be a good partial solution to the problem of the threat of standby letters of credit to bank solvency but perhaps for reasons different from those suggested by its author. Bankers are theoretically already expert credit analysts. The value of creating a special "formula" for the analysis of standby credit transactions would be the raised consciousness of standby credits that would result. It would remind bankers that they must make a thorough credit analysis even

182. *Id.*

183. In *First Empire Bank v. FDIC*, 572 F.2d 1361 (9th Cir. 1978), litigation arising out of the purchase and assumption agreement of U.S. National Bank of San Diego, the FDIC made it very clear that its jealously guarded funds should not be used to make good such "tainted transactions" as the standby letters of credit involved in this case. The court did not adopt its attitude. *Id.* at 1365.

184. See, e.g., *S.L.C. Debate*, *supra* note 111, at 300; Verkuil, note 1 *supra*, at 723.

185. *S.L.C. Debate*, *supra* note 111, at 302, 303.

186. 120 CONG. REC. 29,799 (1974). A memorandum written by Harfield is printed in the Congressional Record.

187. *S.L.C. Debate*, *supra* note 111, at 303.

though the standby credit may not be called upon. It would remind bank examiners that standby credit extensions must be evaluated even if they are not listed in the main body of the balance sheet but in a footnote. Strict examination of standby credit practices would insure that bankers practice self-discipline without rigid legislation to hamper the flexibility of standby letters of credit.

IV. RESOLVING UNCERTAINTIES

The value of certainty in commercial practices cannot be questioned; the efficient working of the marketplace requires it. Businessmen do not readily enter into transactions when risks cannot be evaluated because of uncertainties in the law. As stated above, uncertainties already have undermined the dependability of the standby letter of credit, and they must be resolved. Certainty can be created through legislation, case law, practice, or through a combination of any or all of these areas.

Bankers and their lawyers are adamant in their opposition to legislative restriction of standby letters of credit. Although present legislation is scarce,¹⁸⁸ bankers claim it is sufficient. They contend that problems arising in standby letter of credit controversies are "factual"¹⁸⁹ rather than legal, and thus should be handled by bankers rather than by legislators. The main legal hazard, they argue, is misconception by the judiciary.¹⁹⁰ Since standby letters of credit are non-self-liquidating, a banker must bargain for security outside of the letter of credit contract. They conclude that compliance with already existing law or with possible increased regulation of standby letters of credit would not result in sound banking or enhance security.¹⁹¹

A thorough analysis must be made on each individual transaction. A banker must take into consideration elements for which legislation, because of its rigidity and generality, cannot account. The banker must consider each extension of credit, both to the same customer and overall in respect of the same type of financing.¹⁹² U.C.C. Section 5-102(3) (1972 version) is often called upon to support the contention that the law should adapt to the needs of parties using letters of credit and should not be restrictive.¹⁹³ Legislation should prohibit or restrict only

188. Legislation concerning standby letters of credit consists principally of Article 5 of the U.C.C.

189. *Code, Customs and Conscience*, *supra* note 98, at 8.

190. *Id.* at 9.

191. *See, e.g.*, Harfield, *The Sensible Use of Acceptances and Letters of Credit*, 56 J. COM. BANK LENDING 25, 33 (1973).

192. *Id.* at 32.

193. *See, e.g.*, HARFIELD, *supra* note 48, at 169. U.C.C. § 5-102(3) provides:

that which is invalid and not that which is unsound. Since there is no consensus as to what constitutes sound banking, regulation by restricting the power of banks to perfect their business is not a healthy practice.¹⁹⁴ Furthermore, it must be kept in mind that the letter of credit is a financing tool in international use. In this context, a "parochial" attitude toward the law regarding letters of credit would be unreasonable.¹⁹⁵ The Uniform Customs and Practice for Documentary Credits (U.C.P.),¹⁹⁶ drafted by the International Chamber of Commerce, is particularly suited to creating sound, uniform practices on an international scale. Domestic legislation which interferes with international practices would only place American banks at a further disadvantage in the international market.¹⁹⁷

Arguments against reliance on banking customs and practices to create certainty in the use of standby credits are more convincing than arguments that bankers should be allowed to regulate themselves. Bankers have already proved to be unwilling to promote certainty in standby credit transactions, presumably because uncertainty permits them to decide ambiguities in their favor. New York banking counsel have been able to exercise an inordinate influence on letter of credit law and practice.¹⁹⁸ They have been successful in reducing the importance of Article 5 of the New York Uniform Commercial Code¹⁹⁹ and have precluded the development of clear law and practice of standby letters of credit. They reason that practice and custom as to international letters of credit are uniform among nations and among U.S. banks: the law of letters of credit has become clear, well-settled, known to bank, merchant, bar and bench, as well as uniform among states and

This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article.

194. WARD & HARFIELD, *supra* note 8, at 152.

195. *Code Treatment*, *supra* note 151, at 93.

196. The International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits, Brochure No. 222 (1962 rev.), is the result of a 1926 European congress of various national banking groups.

197. *See* text accompanying note 22 *supra*.

198. Mentschikoff, *Letters of Credit: The Need for Uniform Legislation*, 23 U. CHI. L. REV. 571, 571 (1956).

199. N.Y. U.C.C. § 5-102(4) (McKinney 1964) provides as follows:

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

See WHITE & SUMMERS, *supra* note 6, at 612.

nations.²⁰⁰ In spite of the desirability of such a state of affairs, one need only read a few cases to understand that those statements are true, if at all, only for traditional letters of credit. There is still a real need to develop further the law and practice of standby letters of credit.

Commercial customs cannot replace legislation. Legislation is the only means to provide fair notice and predictability.²⁰¹ Letter of credit users and their lawyers are not necessarily familiar with customary practices even where such customary practices are well-established. A formal set of customary rules such as the U.C.P. can be regarded as no more than a "partial formulation of what bankers feel their liability ought to be."²⁰² Bankers in both the United States and the United Kingdom resisted adoption of the International Chamber of Commerce's 1933 version of the U.C.P.²⁰³ American banks adopted it in 1951, but British banks found it still too imprecise, allowing too much discretion to banks regarding acceptance of documents.²⁰⁴ It was not until 1962, after the U.C.P. was revised to meet the complaints of British bankers, that the British agreed to follow the U.C.P.²⁰⁵

A legislature is more suited than bankers or an international organization such as the International Chamber of Commerce to balance the interest of bankers in extending their services against the interest of bank depositors in sound banking practices. Legislation is more readily enforceable by courts than is custom.

Statutory law is more likely to create clear and fair laws than courts because legislatures have investigative powers and are more directly responsible to the community. Legislation is less likely to be influenced by considerations of equity in particular fact situations, considerations which tend to distract law makers from their purpose of creating laws that will come as close as possible to creating clear, predictable results.

Because of its general applicability, Article 5 of the U.C.C. is the appropriate statute to serve as a source of certainty in letter of credit law. Regulations issued by state or federal agencies have more limited

200. Mentschikoff, *Letters of Credit: The Need for Uniform Legislation*, 23 U. CHI. L. REV. 571, 571 (1956).

201. KOZOLCHYK, *supra* note 45, at 74. See also Shattuck & Guernsey, *Letters of Credit—A Comparison of Article 5 of the Uniform Commercial Code and the Washington Practice*, 37 WASH. L. REV. 325 (1962): "So long as a theoretic hiatus exists letters of credit are vulnerable, and the vulnerability is especially acute in a jurisdiction which has few appellate decisions of the type which can be argued to have impliedly recognized an irrevocable credit to be a legal obligation when issued." *Id.* at 329.

202. KOZOLCHYK, *supra* note 45, at 96.

203. A. LOWENFELD, *INTERNATIONAL PRIVATE TRADE*, pt. 1, at 111 (rev. ed. 1977).

204. *Id.* at 111-12.

205. *Id.* at 112.

jurisdiction.²⁰⁶ An appropriate first step toward clarifying the law would be for the U.C.C. to separate treatment of traditional and standby letters of credit. The two instruments share only a limited number of characteristics. The problems that have proved most unwieldy in standby letter of credit law are irrelevant to traditional letters of credit. Clarification could also be brought about by putting an end to code ambiguities that serve no commercial purpose. U.C.C. section 5-109 states that issuers of letters of credit are not responsible for performance of the underlying contract or for genuineness of documents which are complying on their face "unless otherwise agreed." The implication is that the bank can agree to take responsibility for the underlying contract. Such a notion is inimical to the very essence of the letter of credit—the idea that it deals with documents only and not with performance.

Formal requirements of standby letters of credit could be made more exigent. U.C.C. Section 5-104 requires only that letters of credit be in writing and be signed by the issuer. A separate provision dealing only with standby letters of credit could enumerate requirements such as those listed by the Comptroller of the Currency.²⁰⁷ Whereas the Comptroller presents five features which represent sound banking practice in drafting standby credits without requiring that those features be incorporated into every standby letter of credit,²⁰⁸ the U.C.C. could make those or similar requirements essential to a valid standby letter of credit. Such a requirement would not unduly restrict the development of standbys. National banks already treat the suggested practices as legal requirements.²⁰⁹

None of these attempts at clarification would make U.S. law more obtrusive. The tendency would be to create reliability so that foreign parties would have more confidence in U.S. standby letters of credit.

In the interim, until certainty is created, it is essential that parties

206. Whereas most states have adopted the U.C.C., state and federal regulations are limited in their scope by the authority limits of the agency that promulgated the regulations.

207. The Comptroller has listed five features which should be included in a standby letter of credit:

(a) each letter of credit should conspicuously state that it is a letter of credit, or be conspicuously entitled as such; (b) the bank's undertaking should contain a specified expiration date or be for a definite term; (c) the bank's undertaking should be limited in amount; (d) the bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary; (e) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit.

12 C.F.R. § 7.7016 (1978).

208. *Id.*

209. Interview with Lea Resende, *supra* note 12.

to standby letters of credit be aware of the ambiguities that undermine the reliability of standby credits. Even though there are uncertainties, there is enough settled law and practice concerning standby credits for parties to protect themselves. Before entering into a standby credit contract parties can ascertain that the letter conforms with the requirements of Article 5 of the U.C.C., the U.C.P., and banking regulations. These sources of law are quite broad, but they do present ascertainable requirements. Parties can ensure that the contract is drafted so that it is independent of any other contract and clearly creates a primary obligation on the part of the issuer, one that requires payment conditioned only upon documentary compliance. If a party is aware that there are still many ambiguities surrounding standby credits, then that party will be motivated to inquire into local case law regarding standby credits to see if there are any hazards of which it should be aware and against which it can take precautions.

V. CONCLUSION

The standby credit is a hybrid, an anomaly. Through its form and its history the standby is closely tied to the traditional letter of credit, but the risk is that of an unsecured loan, and it serves the purpose of a guaranty. It is thus no wonder that bankers, legislators, and judges have had great difficulty establishing sound law and practice to govern such a complex instrument. Thus far they have been only partially successful; there are still troubling irregularities which undermine its reliability.

In spite of its problems, however, the standby credit is an immensely valuable, if not essential, instrument to international business transactions. Because of its recognized value, banks, legislatures, and courts will be motivated to create uniform and clear laws and practices. Until the time comes when standby credit practices are understood by all the parties involved with them and until those laws and practices are reliable, parties must take particular care to observe the known requirements of standby credits and to insulate themselves from identified trouble areas.

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