

FRAUD, LETTERS OF CREDIT, AND THE UNIFORM COMMERCIAL CODE:  
IT IS TIME TO UNTETHER THE INDEPENDENCE PRINCIPLE

Richard E. Flint\*

Taking advantage of the vulnerable is a leitmotif of fraud.  
*Competent people can protect themselves well enough  
against most forms of fraud.*<sup>1</sup>

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I. INTRODUCTION

Almost eighty years ago, in the case of *Sztejn v. J. Henry Schroder Banking Corp.*,<sup>2</sup> an appellate court in New York imposed a limit on the independence principle<sup>3</sup> in American letters of credit law by tethering it to a

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\*Albert Hermann Professor of Law, St. Mary's Law School.

<sup>1</sup>Emery v. Am. Gen. Fin., Inc., 71 F.3d 1343, 1347 (7th Cir. 1995) (emphasis added).

<sup>2</sup>31 N.Y.S.2d 631 (N.Y. Special Term 1941).

<sup>3</sup>The independence principle is fully explained in Section III of this Article. Briefly, however, the independence principle is a doctrine in letters of credit law that provides that the undertaking of an issuing bank of a letter of credit to the beneficiary is independent of the underlying contractual

fraud inquiry.<sup>4</sup> Specifically, the *Sztejn* case held that where a beneficiary's fraud was known by the bank that issued the letter of credit prior to its honoring the presentation, the independence of the bank's obligation to honor the presentation would be limited such that the bank could be enjoined from honoring the presentation even though the documents presented strictly complied with the terms and conditions of the letter of credit.<sup>5</sup> There had been earlier cases where there had been evidence of fraud or misrepresentation by the beneficiary of a letter of credit, however, the decisions in those cases were based on other grounds.<sup>6</sup> *Sztejn* involved a sales contract for the purchase and

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arrangement between the applicant of the letter of credit and the beneficiary of the letter of credit, and is also independent of the reimbursement contract between the issuing bank and the applicant for the letter of credit.

<sup>4</sup>See, e.g., Alan Davidson, *Fraud and the UN Convention on Independent Guarantees and Standby Letters of Credit*, 1 GEO. MASON J. INT'L COM. L. 25, 35 (2010) (asserting that the *Sztejn* case "is regarded as the leading case on the fraud exception to the autonomy principle"); John F. Dolan, *Tethering the Fraud Inquiry in Letter of Credit Law*, 21 BANKING & FIN. L. REV. 479, 487 (2005) (stating that common law courts recognized the *Sztejn* case "as playing a central role in the fraud rule"); Gao Xiang & Ross P. Buckley, *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, 13 DUKE J. COMP. & INT'L L. 293, 295 (2003) (recognizing that the seminal case of *Sztejn v. J. Henry Schroder Banking Corp.* "has influenced and shaped the fraud rule in virtually all jurisdictions worldwide"); Ross P. Buckley & Xiang Gao, *The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead*, 23 U. PA. J. INT'L ECON. L. 663, 676 (2003) (noting that the *Sztejn* case "has not only been codified in the Uniform Commercial Code . . . but it has also been cited with approval or followed throughout the common law world"). See also *Intraworld Indus., Inc. v. Girard Tr. Bank*, 336 A.2d 316, 325 (Pa. 1975) (asserting that the *Sztejn* case was "[t]he leading case on the question of what conduct will justify an injunction against honor" of a letter of credit).

<sup>5</sup>*Sztejn*, 31 N.Y.S.2d at 634. The *Sztejn* case will be fully discussed in Section IV of this Article.

<sup>6</sup>*Old Colony Tr. Co. v. Lawyers' Title & Tr. Co.*, 297 F. 152, 156–58 (2d Cir. 1924), *cert. denied*, 265 U.S. 585 (1924) (holding in a breach of contract case that when the issuer knows that the documents presented were false, "he cannot be called upon to recognize such a document as complying with the terms of a letter of credit"); *Higgins v. Steinhardter*, 175 N.Y.S. 279, 280 (N.Y. Sup. Ct. 1919) (holding that although fraud was alleged in the documents presented to the issuer, the court granted an injunction holding that there was a breach of contract such that payment under the credit was unauthorized). However, a year later, the Appellate Division stated that it was of the "opinion that the facts appearing in the opinion of that case (the *Higgins* case) did not warrant the granting of an injunction." *Frey & Son, Inc. v. E.R. Sherburne Co.*, 184 N.Y.S. 661, 664 (N.Y. App. Div. 1920) (stating that payment under letters of credit should not be interfered by courts for mere breach of contract). See also *Maurice O'Meara Co. v. Nat'l Park Bank of N.Y.*, 146 N.E. 636, 639 (N.Y. 1925) (holding that even when an issuer had reasonable doubts as to the quality of the goods delivered, if the documents conformed to the terms of the letter of credit, the issuer was bound to honor the presentation).

sale of bristles by a New York buyer and a seller from India.<sup>7</sup> While the documents required by the letter of credit were facial in strict compliance with the terms of the letter of credit, the buyer alleged that the documents were false and that the seller had shipped rubbish instead of bristles.<sup>8</sup> The buyer sought to enjoin the bank from honoring the draft presented for payment, alleging that although the bank had been advised of the fraud, it was going to honor the presentation, as the documents conformed to the terms of the letter of credit.<sup>9</sup> The bank moved to have the case dismissed for failure to state a cause of action.<sup>10</sup> Given the procedural status of the case, the plaintiff's allegations were deemed true and were not subject to contradiction.<sup>11</sup> The court refused to dismiss the case,<sup>12</sup> holding that a cause of action for injunctive relief was stated because of the fraud in the underlying sales transaction.<sup>13</sup> In reaching its decision, the court stated that when a seller's fraud was called to the bank's attention, the bank's obligation under the letter of credit should not be "extend[ed] to protect the unscrupulous seller."<sup>14</sup> From this humble beginning, the tethering of a fraud inquiry on the independence principle in letters of credit law was birthed, and eventually developed beyond those limited situations where the issuer had actual knowledge of the beneficiary's fraud.

It will be the purpose of this Article to evaluate the efficacy of the fraud exception<sup>15</sup> to the independence principle in letters of credit law in the case of both commercial and standby letters of credit.<sup>16</sup> In doing so, a primary

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<sup>7</sup> *Sztejn*, 31 N.Y.S.2d at 633.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 632.

<sup>10</sup> *Id.* (alleging that the bank "is only concerned with the documents and, on their face, these conform to the requirements of the letter of credit").

<sup>11</sup> *Id.* at 633 (stating also that "every intendment and fair inference is in favor of the pleading" (citations omitted)).

<sup>12</sup> *Id.* at 636.

<sup>13</sup> *Id.* at 634 (noting that, given the status of the case, "it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer").

<sup>14</sup> *Id.* at 634–35 (holding that the independence principle must give way in the case of fraud).

<sup>15</sup> Throughout the Article, the terms "fraud exception" and "fraud rule" are used interchangeably. Furthermore, while this Article's focus is on fraud in the documents presented for honor and material fraud by the beneficiary on the issuer or applicant in a letter of credit transaction, the same rules apply to the situation where there is a forgery in the documents presented for honor.

<sup>16</sup> Throughout the Article, the terms "commercial letter of credit" or "standby letter of credit" may also be referred to as "commercial credit," "standby credit," or just "credit."

focus will be to identify which of the various parties to a letter of credit transaction the present fraud exception “protects,” and to evaluate the policy justifications for why these persons are viewed by the law to be eligible recipients of protection.<sup>17</sup>

Once we can identify the original protected classes and fully understand the policy justifications for such protection, this Article will then evaluate whether these protections are justified in today’s modern world with almost instantaneous communications and unlimited access to worldwide financial accounting information.<sup>18</sup> While the policies justifying the fraud exception may be just as valid today as they were in 1941, the method to achieve them by use of the fraud exception is outdated, unrealistic, economically inefficient in terms of time and money, and overly paternalistic in today’s modern world.<sup>19</sup> A new and different method to achieve these policy justifications is needed. This is especially true as the fraud exception is being increasingly asserted by individuals or entities trying to escape from bad business deals that, with planning and foresight, could have been avoided or prevented in the first place. While the courts today are in large part correctly denying injunctive relief, the time and effort expended in litigation does not justify the continued tethering of the independence principle. Issuers should be free

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<sup>17</sup>Several justifications have been posited for the existence of the fraud exception. *See, e.g.*, Buckley & Gao, *supra* note 4, at 664–67 (listing three policy justifications for the fraud exception); Menachem Mautner, *Letter-of-Credit Fraud: Total Failure of Consideration, Substantial Performance and the Negotiable Instrument Analogy*, 18 L. & POL’Y IN INT’L BUS. 579, 597–604 (1986) (justifying the fraud exception by noting the negative implications of not having a fraud exception). Section V of this Article presents a thorough discussion and evaluation of these authors’ policy justifications.

<sup>18</sup>In the case of foreign public entities, there is the International Financial Reporting Standards (IFRS), which is a set of accounting standards, developed by the International Accounting Standards Board (IASB), that is becoming the global standard for the preparation of public company financial statements. The IASB is an independent accounting standards body, based in London. *See* <https://www.ifrs.com/index.htm>. The mission of the IASB is to develop IFRS® Standards that bring transparency, accountability, and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth, and long-term financial stability in the global economy. *See About Us*, IFRS (last visited Nov. 23, 2018), <https://www.ifrs.org/about-us/>.

<sup>19</sup>*See, e.g.*, Dolan, *supra* note 4, at 481 (arguing for limits on the fraud rule by courts in order to protect the independence principle so as not to destroy letters of credit as unique commercial devices); John F. Dolan, *Standby Letters of Credit and Fraud (Is the Standby Only Another invention of the Goldsmiths in Lombard Street?)*, 7 CARDOZO L. REV. 1, 2 (1985) (arguing that fraud in the transaction under the Prior U.C.C. Article 5 should not be read to refer to the underlying transaction, but solely to the letter of credit transaction).

to comply with their undertaking absent that rare situation where they have actual knowledge of the beneficiary's fraud.

To accomplish these tasks, this Article will trace the American development of the fraud exception since its inception in 1941 until the present date. This evaluation will establish that the fraud exception was incorporated into the case law at a time when merchants in one location were less knowledgeable about their counterparts in other locales and were unable to fully avoid or protect themselves from the risks of fraudulent activities or political upheavals. The inability to determine the credit worthiness or commercial honesty of the parties to the underlying transaction was frustrated by the lack of sophisticated communications systems and the lack of sufficient financial information of the various parties. As this Article will establish, the fraud exception was subsequently incorporated into the Uniform Commercial Code [hereinafter U.C.C.]<sup>20</sup> at a time when the primary concerns were to protect banks and applicants from unscrupulous and fraudulent beneficiaries, and the fraud exception was seen as a sufficient and simple policing mechanism. For, without the fraud exception, the concern was that the applicant would have to reimburse the issuer that honors its letter of credit and then litigate the alleged fraudulent activity, most likely in a distant and unfamiliar forum, against a beneficiary who had already been paid. Of course, as will be shown in this Article, that is what the applicant

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<sup>20</sup>The original U.C.C. was promulgated in the fall of 1951, but was enacted only in Pennsylvania, and was subsequently revised in late 1956 and published as the 1957 Official Text. AMERICAN LAW INSTITUTE & NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE: 1962 OFFICIAL TEXT, *Report No. 1 of the Permanent Editorial Board for the Uniform Commercial Code* vii (1962). In 1958, certain amendments were made to Articles 8 and 9 and the U.C.C. was republished as the "1958 Official Text." *Id.* at viii. Various states adopted the version, but as it became apparent that many states were making their own amendments to the U.C.C. upon adoption, an effort to curb this tendency began, which ultimately resulted in the 1962 Official Text. *Id.* at viii–x. Since 1962, various Articles of the U.C.C. have been revised and even a new Article 4A dealing with Funds Transfers has been approved and incorporated into the U.C.C. This Article's primary focus is on the U.C.C.'s treatment of letters of credit found in Article 5. The original Article 5 was substantially revised for the first time in 1995 after having been approved by the National Conference of Commissioners on Uniform State Laws and the American Law Institute. *See* 2B UNIFORM COMMERCIAL CODE (U.L.A.) 125–35 (Master ed. 2002) (noting that the original Article 5 had been drafted over 40 years ago and then giving a brief history of the revision process and listing the dates of approval by the states of Revised Article 5). *See also* Revised Article §§ 5-101–5-117, 2B UNIFORM COMMERCIAL CODE (U.L.A.) 136–384 (Master ed. 2002). In this Article, the 1995 version of Article 5 will be referred to as Revised Article 5, while the original version of Article 5 will be referred to as Prior Article 5.

bargained for in entering into the underlying contract with the beneficiary that called for payment through a letter of credit. However, in today's world, the diligent applicant should be able to make a truly educated determination of the honesty, financial strength, and credibility of whomever he is entering a contractual relationship with, and should be the one shouldering the economic risks of fraud in the document presentation or in the underlying transaction. Thus, injunctive relief should not be relied upon by the frustrated applicant of the letter of credit. While in the past it has been all too simple to rely on the maxim that fraud unravels all, it is time to expose the fallacy of applying that maxim in the case of modern letters of credit transactions and untether the independence principle from the fraud inquiry.<sup>21</sup>

The Article will start with a brief discussion of the nature of a letter of credit transaction. This part of the Article will identify the various parties and contractual relationships that are involved in a letter of credit transaction. This Article will then discuss the two guiding principles of letters of credit law—the independence principle and the requirement that the documents that are presented under a letter of credit transaction must “strictly comply” with the terms and conditions of the letter of credit. Then this Article will briefly trace the history and development of the fraud exception in letters of credit law and its incorporation into the U.C.C. The Article will then review four recent cases involving the fraud exception. These cases present a common theme that is illustrative of much of today's letter of credit fraud litigation. Specifically, these cases involve applicants who failed to use their business acumen and judgment to protect themselves when entering into an underlying contractual arrangement and then sought the protection of the courts to extricate themselves from a business deal that went awry. In each of the cases, if the applicant had used due diligence, there would never have been a need for judicial interference.

Finally, this Article will propose revising Revised Article 5-109 of the U.C.C. to completely untether the independence principle by eliminating the availability of injunctive, or any other, relief. This proposal is based in part upon the assumption that sophisticated businessmen and entities who have the means to insulate themselves from potential fraud should not expect courts to bail them out of a contractual arrangement that goes sour. This

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<sup>21</sup> See, e.g., *United City Merch. v. Royal Bank of Can.*, 1 A.C. 168, 184 (House of Lords 1983) (stating that “[t]he exception of fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, ‘fraud unravels all.’ The courts will not allow their process to be used by a dishonest person to carry out the fraud”).

proposal is also based upon the fact that, in today's financial world, the reputation of a financial institution is not tarnished by honoring a conforming presentation even if it is subsequently determined that the beneficiary committed fraud in either the documents or the underlying transaction. Furthermore, such an honoring will not destroy the utility of letters of credit. Letters of credit will still form the backbone of financing international commercial transactions and securing performance by a party. If there truly is fraud in the transaction or the documents, the applicant who let all of this unfold in the first place through a lack of due diligence should bear the entire economic ramifications of the failure of the transaction. The legal system should remain out of the letter of credit transaction and let the original contracting parties litigate whatever controversy they have between themselves pursuant to the terms of their original underlying contract. Thus, the issuer should be permitted to follow the untethered independence principle based on its own good faith, and not be subject to any form of litigation from the applicant or others seeking to prevent payment pursuant to the terms and conditions of the letter of credit. Of course, in those limited situations where the issuer has actual knowledge of fraud or forgery in the documents that are presented, or of fraud in the underlying transaction, the issuer alone should have the right in good faith to dishonor the presentation.

## II. THE LEGAL NATURE OF THE LETTER OF CREDIT

Traditionally, letters of credit are classified as either commercial letters of credit or standby letters of credit.<sup>22</sup> Commercial letters of credit are the backbone of the international sale of goods and are used to finance and pay for the merchandise that is the subject of the underlying contract.<sup>23</sup> Standby letters of credit are used in a number of different types of transaction,

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<sup>22</sup>See Richard F. Dole, Jr., *The Effects of UCP 600 Upon UCC Article 5 with Respect to Negotiation Credits and the Immunity of Negotiating Banks from Letter-of-Credit Fraud*, 54 WAYNE L. REV. 735, 739 (2008).

<sup>23</sup>See generally WHITE ET AL., 3 UNIFORM COMMERCIAL CODE, PRACTITIONER TREATISE SERIES ¶16:2 162–64 (6th ed. 2014). It is important to note that the volume of world-wide seaborne trade has grown 4 percent in 2017 (the fastest increase in over 5 years with total volumes reaching 10.7 billion tons). See *Review of Maritime Transport*, 2018, U.N. CONF. ON TRADE & DEV. x (2018), [https://unctad.org/en/PublicationsLibrary/rmt2018\\_en.pdf](https://unctad.org/en/PublicationsLibrary/rmt2018_en.pdf) (projecting growth at 4% in 2018).

typically not involving the sale of goods, and acts as a payment guarantee<sup>24</sup> or security for the beneficiary in the case of the applicant's defective performance or nonperformance of its contractual obligations arising from the underlying contract.<sup>25</sup> In a typical letter of credit transaction, there are three primary parties—the applicant, the issuer, and the beneficiary.<sup>26</sup> In

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<sup>24</sup>While the standby credit may act as a guarantee, it is not a guarantee as noted by a court in the following language:

We first note that a standby letter of credit itself does not create a suretyship. A standby letter of credit functions somewhat like a guaranty, given that it is the applicant's default that triggers the beneficiary's ability to draw on the letter of credit. But a true letter of credit arrangement is not a guaranty. First and foremost, the issuer's obligation to pay upon presentation of conforming documents is a primary obligation, not a secondary one. Although default may trigger a draw, it is only upon proper certification of the applicant's default that the issuer is obligated to pay.

CRM Collateral II, Inc. v. TriCounty Metro. Transp. Dist. of Or., 669 F.3d 963, 969 (9th Cir. 2012) (citation and internal quotation marks omitted).

<sup>25</sup>One commentator asserted that, if a letter of credit is not a commercial letter of credit, it is a standby letter of credit. Dole, *supra* note 22, at 740 (following his brief description of a commercial letter of credit, the author simply states that “[a]ll other letters of credit can be regarded as standbys” (footnote omitted)). Another commentator notes, however, that there are significant differences between the two types of letters of credit. First, the beneficiary of a standby letter of credit must certify that his obligor has defaulted on his contractual obligations. In a commercial letter, the beneficiary must present the required documents in order to receive payment for merchandise shipped under a contract of sale. Secondly, the issuer of a commercial credit assumes that it will pay the seller's drafts, whereas the issuer of the standby credit generally does not expect to pay. Finally, the documents presented by the beneficiary in the commercial credit are generally always the same, whereas the documents presented in a standby credit are generally unique to the underlying transaction, which generally involves a number of non-sale situations. See John F. Dolan, THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS ¶1.04, 1–15 to 1–17 (2d ed. 1991).

One court has explained the difference between the two letters of credit as follows:

Unlike a traditional commercial letter of credit, which is commonly used in commercial sales to reduce the risk of nonpayment for goods, standby letters of credit are used in the non-sale setting and serve to reduce the risk of nonperformance under a performance contract. To draw on the letter, the beneficiary is typically required to produce documents certifying the applicant has defaulted on its underlying obligation to the beneficiary.

CRM Collateral II, 669 F.3d at 969.

<sup>26</sup>The U.C.C. defines these three as follows:

(2) “Applicant” means a person at whose request or for whose account a letter of credit is issued. The term includes a person who requests an issuer to issue a letter of credit on



addition to these three main parties to a letter of credit transaction, other parties could be involved—such as, advisors,<sup>27</sup> confirmers,<sup>28</sup> or a nominated person.<sup>29</sup>

The three primary parties are loosely interrelated by three separate and distinct contractual relationships. First, there is the underlying contract between the applicant and the beneficiary that provides that payment will be made through a letter of credit. The underlying contract will also specify that the applicant will make an application with an issuer for the issuance of an irrevocable letter of credit. Thus, under an underlying sales contract, the applicant has an obligation to pay for the goods and the beneficiary agrees to obtain payment by drawing drafts<sup>30</sup> under a letter of credit to be procured

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behalf of another if the person making the request undertakes an obligation to reimburse the issuer.

(3) “Beneficiary” means a person who under the terms of a letter of credit is entitled to have its complying presentation honored. The term includes a person to whom drawing rights have been transferred under a transferable letter of credit.

(9) “Issuer” means a bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purposes.

U.C.C. § 5-102(2), (3), & (9).

<sup>27</sup>The U.C.C. defines an advisor as follows: “‘Adviser’ means a person who, at the request of the issuer, a confirmer, or another adviser, notifies or requests another adviser to notify the beneficiary that a letter of credit has been issued, confirmed, or amended.” *Id.* § 5-102(1).

<sup>28</sup>The U.C.C. defines a confirmer as follows: “‘Confirmer’ means a nominated person who undertakes, at the request or with the consent of the issuer, to honor a presentation under a letter of credit issued by another.” *Id.* § 5-102(4).

<sup>29</sup>The U.C.C. defines a “nominated person” as follows:

“Nominated person” means a person whom the issuer:

(i) designates or authorizes to pay, accept, negotiate, or otherwise give value under a letter of credit; and

(ii) undertakes by agreement or custom and practice to reimburse.

*Id.* § 5-102(11).

<sup>30</sup>Article 3 of the U.C.C. deals with negotiable instruments. Revised Article §§ 3-101–3-605, 2 UNIFORM COMMERCIAL CODE (U.L.A.) 23–354 (Master ed. 2004) [hereinafter cited as U.C.C. § 3 Section Number]. A “draft” is an order to pay money. U.C.C. § 3-104(a), (e). A “drawer” is the person ordering payment who signs the draft. *Id.* § 3-103(a)(5). The “drawee” is the person ordered to pay the draft. *Id.* § 3-103(a)(4). A draft in negotiable form is an order to pay money that is subject to the provisions of the U.C.C. dealing with negotiable instruments. *Id.* § 3-102(a). In a letter of credit transaction, the draft utilized in conjunction with the transaction is typically drawn by the

from an issuer by the applicant.<sup>31</sup> The applicant and the issuer would enter into the second contract (generally referred to as a reimbursement contract<sup>32</sup>), under which the bank agrees to issue an irrevocable letter of credit in favor of the beneficiary and the applicant agrees to reimburse the bank when, and if, it honors<sup>33</sup> a presentation under the letter of credit by payment. Pursuant to the terms of this second contract, the issuer is obliged to go forward with issuing the letter of credit with the terms and conditions requested by the applicant.<sup>34</sup> The issuing bank can inform the beneficiary directly of the issuance letter of credit and its terms.<sup>35</sup>

The third contractual relationship is the letter of credit itself. The issuer accepts the reimbursement contract by issuing the letter of credit, which is the bank's irrevocable undertaking<sup>36</sup> to perform its obligations pursuant to

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beneficiary as drawer, upon the issuer or a confirmer as drawee, and may or may not be in negotiable form and therefore subject to Article 3. *See id.* § 5-102, cmt. 11 (“[A] document may be a draft under Article 5 even though it would not be a negotiable instrument [under Article 3].”). It should be noted that, in the event of a conflict between Article 3 and Article 5, Article 5 governs. *See id.* § 5-116(d).

<sup>31</sup>The comments to Article 5-102 state the obvious: that this contract is not governed by Article 5 of the U.C.C., but by either Article 2 of the U.C.C., if the contract involves the sale of goods, or otherwise by the general law of contracts. *See* U.C.C. § 5-102, cmt. 3.

<sup>32</sup>*See id.* (stating that the contract between the applicant and the issuer is sometimes called the “reimbursement agreement”). *See also id.* § 5-108(i)(1) (noting that an issuer that honored a presentation is entitled to be reimbursed by the applicant).

<sup>33</sup>*Id.* § 5-102(8) defines “honor” for purposes of Revised Article 5 as follows:

“Honor” of a letter of credit means performance of the issuer’s undertaking in the letter of credit to pay or deliver an item of value. Unless the letter of credit otherwise provides, “honor” occurs:

- (i) upon payment;
- (ii) if the letter of credit provides for acceptance, upon acceptance of a draft and, at maturity, its payment; or
- (iii) if the letter of credit provides for incurring a deferred obligation, upon incurring the obligation and, at maturity, its performance.

*Id.* § 5-102(8).

<sup>34</sup>*See id.* § 5-102, cmt. 3 (stating that this contract is governed in part by Revised Article 5 and partly by the general law of contracts).

<sup>35</sup>*See id.* § 5-106(a) (providing that the letter of credit “is issued and becomes enforceable against the issuer” when the letter is sent or transmitted to an adviser or the beneficiary).

<sup>36</sup>The U.C.C. defines a “letter of credit” as follows:

“Letter of credit” means a definite undertaking that satisfies the requirements of Section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in

the terms and conditions of the credit. The letter of credit unconditionally obligates the bank to honor a presentation of a draft or demand for payment that is tendered by the beneficiary along with whatever other documents the letter of credit may require be presented. In the case of a commercial letter of credit, these documents relate to the seller's performance of the underlying sales transaction and may generally include the seller's demand for payment or draft, seller's commercial invoice, and shipping documents (most likely a bill of lading<sup>37</sup>) that reflect that the goods have been shipped.<sup>38</sup> A standby

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the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

*Id.* § 5-102(10).

U.C.C. § 5-104 states: "A letter of credit, confirmation, advice, transfer, amendment, or cancellation may be issued in any form that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties or the standard practice referred to in Section 5-108(e)." *Id.* § 5-104.

U.C.C. § 5-108(e) states: "An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer's observance of the standard practice is a matter of interpretation for the court. The court shall offer the parties a reasonable opportunity to present evidence of the standard practice." *Id.* § 5-108(e).

*See also id.* § 5-101, Official Comment (describing a "letter of credit as an idiosyncratic form of undertaking that supports performance of an obligation incurred in a separate financial, mercantile, or other transaction or arrangement").

<sup>37</sup>Article 1, Part 2 of the U.C.C. deals with General Definitions and Principles of Interpretation. *See* Revised Article §§ 1-201–1-206, 1 UNIFORM COMMERCIAL CODE (U.L.A.) 23–56 (Master ed. 2012) [hereinafter cited as U.C.C. § 1 Section Number]. One of the definitions provided in Article 1, Part 2 is for the term "bill of lading." It is defined as: "'Bill of lading' means a document evidencing the receipt of goods for shipment issued by a person engaged in the business of transporting or forwarding goods." U.C.C. § 1-201 (6). A bill of lading is a document of title and provisions in Article 7 of the U.C.C. specifically apply to bills of lading. *See* Revised Article §§ 7-301 to 7-603, 2C UNIFORM COMMERCIAL CODE (U.L.A.) 120–191 (Master ed. 2005) [hereinafter cited as U.C.C. § 7 Section Number]. Bills of lading play a key role in international trade because such trade is usually carried out using a bill of lading. *See* INDIRA CARR, INT'L TRADE L. 229 (4th ed. 2010).

<sup>38</sup>*See, e.g.,* United Commodities-Greece v. Fid. Int'l Bank, 478 N.E.2d 172, 173–74 (N.Y. 1985) (requiring presentation of "a warehouse or dock receipt issued to the order accompanied by a bank guarantee that beneficiary will load the goods on first demand of orderer and remit to the negotiating bank, free of charges, the covering Bill of Lading"); *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631, 633 (N.Y. Special Term 1941) (requiring presentation of a draft, invoice, and bill of lading covering the shipment). Other documents can be required pursuant to the terms and conditions of the letter of credit, such as an inspection certificate by an independent testing agency to assure the buyer that the seller has performed his contractual obligations concerning the conformity of the goods. *See, e.g.,* ACR Sys., Inc. v. Woori Bank, 232 F. Supp. 3d 471, 474

letter of credit, like the commercial letter of credit, calls for payment against the presentation of specified documents and is frequently used to assure payment to the beneficiary upon contractual default by the applicant.<sup>39</sup> Typically, in the case of a standby letter, the only documents necessary for presentation by the beneficiary are a sight draft or demand for payment and/or a signed certificate or letter stating or certifying that the applicant has not performed under the terms of the underlying contract between the applicant and the beneficiary.<sup>40</sup> In either case, the beneficiary is assured of payment

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(S.D.N.Y. 2017) (requiring not only a bill of lading and the commercial invoice, but also an inspection certificate from the person receiving the goods for shipping).

<sup>39</sup>A listing of cases involving standby letters of credit establish that they are used in various situations and act as guarantees in those cases where the applicants default on their contractual obligations. *See, e.g.*, *Mago Int'l v. LHB AG*, 833 F.3d 270, 271 (2d Cir. 2016) (involving a standby letter of credit to be drawn upon failure of the buyer to timely pay invoices for the purchase of meat products); *Langley v. Prudential Mortg. Capital Co.*, 546 F.3d 365, 367 (6th Cir. 2008), *reh'g denied*, 554 F.3d 647 (6th Cir. 2009) (using a standby letter of credit to secure a rate lock deposit for a substantial loan to purchase and develop real estate); *Great Wall de Venezuela C.A. v. Interaudi Bank*, 117 F. Supp. 3d 474, 479 (S.D.N.Y. 2015) (involving a letter of credit covering three installments for the purchase of company shares and an automobile assembly plant in Venezuela); *Hook Point, LLC v. Branch Banking & Tr. Co.*, 725 S.E.2d 681, 682 (S.C. 2012) (using of a standby letter of credit in the case a real estate developer failed to perform its obligations under a development loan); *Ladenburg Thalmann & Co. v. Signature Bank*, 6 N.Y.S.3d 33, 34 (N.Y. App. Div. 2015) (securing a subtenant's payment of rent by the use of a standby letter of credit); *Lennar Homes, L.L.C. v. Ventures, LLC*, 988 So. 2d 660, 661 (Fla. D.C. App. 2008) (securing a seller of real estate by means of a standby letter of credit payable in the event the buyer defaulted in the purchase). *See also* JAMES G. BARNES ET AL., *THE ABCS OF THE UCC: ARTICLE 5: LETTERS OF CREDIT* 8–9 (1998) (listing various ways that standby letters of credit have been used).

<sup>40</sup>*See, e.g.*, *3M Co. v. HSBC Bank U.S.A., N.A.*, 16 Civ. 5984 (PGG), 2018 WL 1989563, at \*5 (S.D.N.Y. Apr. 25, 2018) (involving a standby letter of credit requiring only a demand for payment and a written statement that the immediate beneficiary had received a demand for payment under second letter of credit in accordance with that letter of credit's terms); *Hook Point*, 725 S.E.2d at 682 (involving a standby letter of credit that the beneficiary was permitted to make draws against upon presentation of drafts and a notarized sworn statement that the applicant had failed to perform its obligations).

Standby letters of credit are often used in construction contracts in foreign countries by and between an American Contractor and an entity that is owned or controlled by the government (or a governmental agency) of the foreign country where the project is to be done. In those situations, there is generally a requirement in the underlying construction contract that a local bank in the foreign country issue a performance guarantee or bond to ensure the American contractor performs its work according to the terms of the contract. The bank issuing the performance guarantee typically requires that a standby letter of credit be issued on the applicant's bank that is payable upon a payment demand and a letter stating that there was a call on the foreign bank to pay under its

upon proper presentation of the documents, and the applicant is assured that the beneficiary's presentation will not be honored until the proper documentation is presented to the issuer. If the documents comply, the issuer honors the draft or demand for payment generally by immediately paying the beneficiary. In the case of a commercial letter of credit, the beneficiary will typically endorse the negotiable bill of lading to the order of the issuer as additional security for the payment made to the beneficiary.<sup>41</sup> Thus, in the

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performance bond or guarantee. For example, in *Archer Daniels Midland Co. v. JP Morgan Chase Bank, N.A.*, No. 11 Civ. 0988 (JSR), 2011 WL 855936, at \*2 (S.D.N.Y. Mar. 8, 2011), the letter of credit issued by JP Morgan stated in part that: "[Funds are] . . . available against your authenticated Swift/Tested Telex that you have duly issued your Performance Bond as requested by ourselves and that you have received a claim in accordance with the terms of the performance bond."

The Iranian Revolution of 1979 was a fruitful source of litigation in standby letters of credit. Like many of the construction contracts that form a major portion of standby letters of credit, there were typically four parties involved in the cases that arose: an American company, an Iranian governmental agent, an Iranian bank, and a United States Bank. The performance of the contract between the American company and the Iranian governmental agency was guaranteed by a performance bond or guarantee issued by an Iranian Bank. These performance bonds or guarantees were securitized with a letter of credit issued by an American bank. After the Iranian Revolution, fearing fraudulent calls on the Iranian bank's performance bond or guarantees and then calls to honor the letter of credit, American companies flocked to the courts to seek protection. Most of the requests for injunctive relief were denied before the taking of the hostage at the U.S. Embassy in Teheran in November of 1979, while in the post-hostage cases, a majority of the injunctions were granted. *See, e.g.*, Mark P. Zimmitt, *Standby Letters of Credit in the Iran Litigation: Two Hundred Problems in Search of a Solution*, 16 L. & PUB. POL'Y INT'L BUS. 927, 930, 943 (noting only marginal success prior to the hostage crisis, whereas, out of 14 post hostage cases filed in district court, 12 were granted). *Compare* *Am. Bell Int'l, Inc. v. Islamic Republic of Iran*, 474 F. Supp. 420, 426 (S.D.N.Y. 1979) (denying pre-hostage injunctive relief by simply noting that both Bell (the applicant) and the issuing American bank were innocent parties, but "as between two innocents, the party who undertakes by contract the risk of political uncertainty and governmental caprice must bear the consequences when the risk comes home to roost"), *with* *Harris Corp. v. Nat'l Iranian Radio & Television*, 691 F.2d 1344, 1356 (11th Cir. 1982) (granting, in a post-hostage case, injunctive relief on grounds that "NIRT's [beneficiary] demand was made in a situation that was subtly suggestive of fraud since NIRT and Bank Melli (the Iranian Bank that had issued the performance guarantee) had both become government enterprises, the demand was in some sense by Iran upon itself and may have been an effort by Iran to harvest undeserved bounty from Continental Bank (the issuer)"). Given the change in attitude toward granting injunctive relief in the post-hostage situation, one commentator suggested that the change in attitude may have been "influenced by the widespread sentiment that Iran should be punished." *See* Zimmitt, *supra*, at 946.

<sup>41</sup> *See, e.g.*, Xiang Gao, *The Fraud Rule Under the UN Convention on Independent Guarantees and Standby Letters of Credit: A Significant Contribution from an International Perspective*, 1 GEO. MASON J. INT'L COM. L. 48, 51 (2010) (stating that, upon paying the seller, the bank acquires a security over the documents to secure the advance made financing the transaction); Buckley & Gao,

typical commercial letter of credit transaction, the seller is the beneficiary of the credit, while in a traditional standby letter of credit, the party who entered into the underlying contract with the applicant is the beneficiary.<sup>42</sup>

In either case, the purpose of the letter of credit is to accomplish a shifting of risks and the costs associated with those risks from one party to the other party.<sup>43</sup> In the commercial sales transaction, if there were no letter of credit or other assurance for performance, such as a guarantee or performance bond, the seller carries the risk of not getting paid after it has manufactured or acquired the merchandise to be sold and shipped it the purchaser. Furthermore, the seller will have to litigate the breach of contract in a possibly distant or foreign forum without the funds for the sale. If, however, a letter of credit is involved, the seller could get paid upon shipping and

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*supra* note 4, at 666–67 (2002) (noting that the agreement between the applicant and the issuer will provide that the merchandise will be additional security for the issuer’s honor of the presentation).

<sup>42</sup>It should be noted that even in a commercial sales transaction, the parties can use a standby letter of credit to ensure that the seller gets paid after delivering on an open account and its invoices are unpaid. *See, e.g., Mago*, 833 F.3d at 271 (using a standby letter of credit to ensure that the seller got paid in the event the buyer did not timely pay the invoices for sale of chickens).

<sup>43</sup>One well-known commercial law commentator explained the risks associated with a letter of credit in the following words:

Under letter of credit practice and law, the applicant bears the risk of disputes regarding the performance of the underlying transactions that gave rise to the letter of credit. In effect, the letter of credit represents an allocation of the risk of who holds funds pending the resolution of these disputes. In the ordinary case under a letter of credit, the beneficiary is entitled to hold the funds until things can be sorted out. Although payment to the beneficiary is final with respect to the letter of credit obligation, the obligation that gave rise to it remains and may be a basis for recovery by the applicant to the credit or any assignee of its rights in a post-payment action against the beneficiary on the underlying transaction. The abstract status of the beneficiary, therefore, can be understood as temporary or interim. That of the LC issuer or nominated bank is permanent. The rule protects these banks, as it should, if the system is to have currency, since where these banks, as intermediaries, have in good faith paid funds to the fraudster pursuant to their undertaking or nomination, they ought to be able to obtain reimbursement. Assuming that lending or credit decisions were sound, the loss will be thrown onto the applicant who either elected to deal with the beneficiary or used its credit to obtain the LC for the person who did so.

James E. Byrne, *Negotiation in Letter of Credit Practice and Law: The Evolution of the Doctrine*, 42 TEX. INT’L L.J. 561, 580–81 (2007) (footnote omitted). *See also* Mautner, *supra* note 17, at 596 (1986) (explaining that the independence rule does not conclusively establish the rights and duties of the parties, but merely allocates the roles of plaintiff and defendant between them).

before the buyer gets the goods by presenting the required documents.<sup>44</sup> Thus, the risks and costs associated with those risks are shifted to the buyer who now must reimburse the issuer following its honor of the presentation and pursue the seller for breach of contract in a possibly distant or foreign forum.<sup>45</sup> A transaction associated with a standby letter of credit works in a similar manner to shift risks and the costs associated with those risks. For example, when a contractor enters into a contract with a developer to build a warehouse in a foreign country and does not provide a letter of credit or a performance bond from a surety company and fails to perform, the developer must employ another contractor to do the work at his own cost. He can also seek his remedies under the contract through litigation in a possibly distant or foreign forum on his own dollar. If, however, the contractor was obligated to get a letter of credit, the developer could obtain funds to finish the project

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<sup>44</sup>The advantages for the beneficiary in a commercial letter of credit transaction was succinctly stated by a Texas court in the following language:

Contracting parties may use a letter of credit in order to “make certain that contract disputes [between the applicant and beneficiary] wend their way towards resolution with money in the beneficiary’s pocket rather than in the pocket of the [applicant].” The beneficiary’s immediate right of possession of the funds on payment of the letter of credit does not decide the dispute over who will ultimately retain those funds. “Without this rule, the beneficiary of the letter of credit would be the ultimate arbiter of compliance with the underlying contract and the commercial viability of the letter of credit would be destroyed.” Thus, the letter of credit determines the beneficiary’s right to immediate possession of the funds on presentation of conforming documents to the issuer, *but not the right to ultimately retain those funds.*

Sava Gumarska in Kemijska Insustria D.D. v. Advanced Polymer Sci., Inc., 128 S.W.3d 304, 319 (Tex. App.—Dallas 2004, no pet.) (citing CKB & Assocs., Inc. v. Moore McCormack Petroleum, Inc., 734 S.W.2d 653, 655 (Tex. 1978)) (emphasis added).

<sup>45</sup>*See, e.g.*, CRM Collateral II, Inc. v. TriCounty Metro. Transp. Dist., 669 F.3d 963, 969 (9th Cir. 2012) (describing the typical letter of credit arrangement, including the reimbursement contract between the applicant and the issuer, obligating the applicant to reimburse the issuer when payments are made under the terms of the letter of credit). The issuer, of course, has certain risks that it must address. First, the issuer takes the risk of the applicant’s insolvency. Thus, the issuer needs to evaluate the applicant’s credit worthiness and financial capabilities before agreeing to issue the letter of credit. *See generally* BARNES ET AL., *supra* note 39, at 2–3 (stating that the buyer is not out any up-front funds for the purchase of the merchandise, and only becomes obligated to reimburse the bank when it honors its letter of credit). In many situations, the issuer will require that the applicant provide collateral to secure the obligation to reimburse. *See, e.g.*, Jaffe v. Bank of Am., N.A., 667 F. Supp. 2d 1299, 1310 (S.D. Fla. 2009), *aff’d* 395 F. App’x 583 (11th Cir. 2010) (stating that the beneficiary mortgaged some of his property to guarantee the issuer’s letter of credit).

by the presentation of a draft and a written statement certifying that the applicant had failed to perform its contracted obligations.<sup>46</sup> If the contractor believes that the developer wrongfully drew on the letter of credit, the contractor would have to pursue the developer in a possibly distant or foreign forum on its own dollar. Thus, the risks and many of the costs are shifted from the developer to the contractor. Thus, while the letter of credit does not allocate the ultimate loss between the parties to the underlying transaction, it shifts the risks and the costs associated with those risks between the parties. After the issuer has honored a presentation, the buyer who has received defective merchandise (commercial letter of credit) or alleges that he did not breach the underlying contract (standby letter of credit) is free to sue the other party to recover his losses. As we will see in the next section, the “independence” principle prevents the issuer from raising the buyer’s/contractor’s defenses to the underlying sales contract or other contractual arrangement, but that principle does not foreclose suit on those claims by the buyer/contractor after payment under the credit.

### III. GUIDING PRINCIPLES OF LETTERS OF CREDIT LAW: THE INDEPENDENCE PRINCIPLE AND THE PRINCIPLE OF STRICT COMPLIANCE

The cornerstone of letters of credit law is the independence principle—that is, that the three contractual arrangements described above are not dependent upon each other but are totally independent from each other.<sup>47</sup> Each of these

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<sup>46</sup>See, e.g., *Sperry Int’l Trade, Inc. v. Gov’t of Israel*, 670 F.2d 8, 9 (2d Cir. 1982) (requiring only a sight draft and Israel’s own “certification that it is entitled to the amount covered by such draft by reason of a clear and substantial breach” of the construction contract). See also *Ace Am. Ins. Co. v. Bank of Ozarks*, No. 11 Civ. 3146 (PGG), No. 11 Civ. 3146 (PGG), 2014 WL 4953566, at \*10 (S.D.N.Y. Sept. 30, 2014) (requiring only a sight draft containing a reference that it was drawn under the specific letter of credit).

<sup>47</sup>The underlying principle of the letters of credit law is the independence of the three separate and distinct arrangements among the parties. See, e.g., *Compass Bank v. Morris Cerullo World Evangelism*, 699 F. App’x 184, 186–87 (9th Cir. 2017) (referring to the fact that the issuer’s obligation under the letter of credit was independent of other contracts); *Jaffe v. Bank of Am., N.A.*, 395 F. App’x 583, 591 (11th Cir. 2010) (stating that the well-established principle is that the issuer’s obligation to the beneficiary is independent of any party’s performance under the underlying contract); *In re Onecast Media, Inc.*, 439 F.3d 558, 564 (9th Cir. 2006) (noting that each of the three arrangements involved in a letter of credit situation “must be treated separately”); *Alaska Textile Co. Inc. v. Chase Manhattan Bank, N.A.*, 982 F.2d 813, 815 (2d Cir. 1992) (asserting that the three relationships are “utterly independent of each other,” giving great utility to the letter of credit);



three relationships is considered separate and distinct in its operation and performance.<sup>48</sup> The independence principle is principally incorporated into the Revised U.C.C. in the following language:

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Voest-Alpine Trading Co. v. Bank of China, 167 F. Supp. 2d 940, 944 (S.D. Tex. 2000) (stating that “[t]he underlying principle of the letter of credit transaction is the independence of the three contracts” (citing Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 235 (5th Cir.1983))); Benecke v. Haebler, 58 N.Y.S. 16, 17–18 (N.Y. App. Div. 1899), *aff’d* 60 N.E. 1107 (N.Y. 1901) (holding that the issuer had no duty to “ascertain, before accepting, whether the goods shipped corresponded in quality to the goods ordered”). *See also* Rufus James Trimble, *The Law of Merchant and the Letter of Credit*, 61 HARV. L. REV. 981, 1006 (1948) (stating that “[i]t is inherent in the nature of a letter of credit that neither the contractual relationship between the issuer and its customer, nor that between the customer and beneficiary is relevant to the question of the enforceability of the letter” (citations omitted)).

As one commentator noted:

Revised Article 5 clearly and forcefully states the independence of the letter of credit obligations from the underlying transaction that was unexpressed in, but was a fundamental predicate for, the original Article 5 (Sections 5-103(d) and 5-108(f)). Certainty of payment, independent of other claims, setoffs or other cause of action, is a core element of the commercial utility of letters of credit.

BURTON V. MCCULLOUGH, *LETTERS OF CREDIT: 1995 UNIFORM COMMERCIAL CODE: REVISED ARTICLE 5 WITH ANALYSIS AND COMMENTARY* 11 (1996).

<sup>48</sup>The independence of these three relationships was succinctly stated as follows:

Each of the three transactions involved in letter of credit financing are separate and independent from the others. The duties of the obligor and obligee under the underlying contract are not affected by a bank’s agreement to furnish a letter of credit and are not affected by issuance of the letter itself. The Bank’s duty to its customer to issue the letter of credit is not affected by the existence or performance of the underlying contract. The Bank’s commitment to honor its letter, once issued, is not affected by its customer’s failure to provide consideration for issuance of the letter or by the beneficiary’s failure to perform its obligations under the underlying contract. The purpose of this independence is to guarantee an obligee of the underlying contract (in this case, Israel Discount Bank of New York) that it will be paid and to shift all risks of non-payment from such obligee to a bank (in this case to the Mercantile National Bank) which is better able than the obligee to analyze the obligor’s financial stability and protect itself in the event of the obligor’s default.

*In re Originala Petr. Corp.*, 39 B.R. 1003, 1007 (Bankr. N.D. Tex. 1984). *See also* Bank of Nova Scotia v. Angelica-Whitewear Ltd., 36 D.L.R.4th 161, 166 (Sup. Ct. Can. 1987) (asserting that “[t]he fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of

Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises, or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.<sup>49</sup>

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the underlying contract for which the credit was issued”); *Alaska*, 982 F.2d at 815 (stating that the “principle infuses the transaction with the simplicity and certainty that are its hallmarks”); *Marino Ind. Corp. v. Chase Manhattan Bank, N.A.*, 686 F.2d 112, 115 (2d Cir. 1982) (stating that “[i]t is the complete separation between the underlying commercial transaction and the letter of credit that gives the letter its utility in financing transactions”); *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 360 N.E.2d 943, 948 (N.Y. 1976) (stating that issuers deal in documents, not goods, and have no responsibility for performance of the underlying contract).

The independence principle has been part of commercial letter of credit law since the middle of the nineteenth century. *See* HENRY HARFIELD, *BANK CREDITS AND ACCEPTANCES* 158–62 (4th ed. 1974) (reproducing Karl Llewellyn’s Commentary on the development of the commercial letter of credit in the middle of the nineteenth century). *See generally* Boris Kozolchik, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 *AM. J. COMP. L.* 395, 398 (1965) (stating that, after the middle of nineteenth century, the commercial letter of credit gained favor with merchants in the United States and Europe).

<sup>49</sup>U.C.C. § 5-103(d). Other sections of Article 5 also impact the application of the independence principle. *See id.* § 5-108(a) (requiring that the documents presented for payment must strictly comply with the terms of the credit); *id.* § 5-108(f) (stating that the issuer has no responsibility for performance of the underlying contract); *id.* § 5-102(a)(10) (defining a letter of credit as an undertaking to honor a documentary presentation); *id.* § 5-109 (authorizing honor by the issuer in good faith even in the face of claims of fraud). *See also id.* § 5-102, cmt. 3 (articulating the relationship between the good faith requirement and the independence principle); *id.* § 5-103, cmt. 1 (differentiating letters of credit from guarantees on the availability of defenses asserted on underlying contracts).

The independence principle was not directly mentioned in the Prior U.C.C., but that document provided that the issuer’s obligation to its customer did not include liability or responsibility “for performance of the underlying contract for sale or other transition between the customer and the beneficiary.” Prior Art. 5-109 (1)(a), 2B, Part 2, *UNIFORM COMMERCIAL CODE* (U.L.A.) 109 (Master ed. 2004) [hereinafter references to the Prior U.C.C. Article 5 will be cited as Prior U.C.C. § 5 Section Number]. The Official Comment to Prior U.C.C. Section 5-109 fleshed out this provision as follows:

Paragraph (a) rests on the assumptions that the issuer has had no control over the making of the underlying contract or over the selection of the beneficiary, and that the issuer receives compensation for a payment service rather than for a guaranty of performance.

An Official Comment to U.C.C. Section 5-103 explains the drafter's intent of this Section as follows:

In letter of credit law, on the other hand, the independence principle recognized throughout Article 5 states that the issuer's liability is independent of the underlying obligation. That the beneficiary may have breached the underlying contract and thus have given a good defense on that contract to the applicant against the beneficiary is no defense for the issuer's refusal to honor. Only *staunch recognition* of this principle by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit. To that end, it is important that the law not carry into letter of credit transactions rules that properly apply only to secondary guarantees or to other forms of engagement.<sup>50</sup>

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The customer will normally have direct recourse against the beneficiary if performance fails . . . .

Prior U.C.C. § 5-109, cmt. 1.

<sup>50</sup>U.C.C. § 5-103, cmt. 1 (emphasis added). Although, the letter of credit functions like a guaranty, there are two major differences between the letter of credit arrangement and the standard guaranty. *See id.* (noting that guarantees are undertakings typically "used to describe a suretyship relationship in which the 'guarantor' is only secondarily liable and has the right to assert the underlying debtor's defenses"). However, the issuer of a letter of credit is unconditionally liable to the beneficiary and cannot set up defenses that the applicant might raise against the beneficiary. *See also* David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT'L L. REV. 51, 66 (2005) (noting that a guarantor is liable only if the principal obligor defaults); *Border Nat'l Bank v. Am. Nat'l Bank*, 282 F. 73, 77 (5th Cir. 1922) (stating that a "guaranty is a promise to answer for the payment of some debt, or the performance of some obligation, in case of default of another person, who is in the first instance liable for such payment or performance").

The distinctions between the two were succinctly stated in Mr. Harfield's leading text:

A proper letter of credit is an independent contract that states all of the conditions defining the rights and obligations of the parties. A dispute as to those rights or obligations must be resolved by reference only to the letter of credit and not to any other contract or relationship. A guaranty is a contract that is ancillary to some other contract or relationship, so that a dispute as to the rights or obligations of parties to the contract of

Issuers are obliged to honor draws under letters of credit that meet the documentary requirements of the letter even if the applicant has a complaint about the beneficiary's performance. Assume, for example, that a seller had a contract to deliver certain merchandise to a buyer, but the merchandise delivered did not conform to the terms of the sales contract. The buyer's cause of action for breach of warranty does not give the issuer—who is unconditionally obligated to pay on seller's presentation of an invoice, a bill of lading and, perhaps, other documents—the right to refuse payment when the required documents are presented. The issuer's legal obligation—to pay on the documents alone—is the application of the independence principle. Issuers must honor a presentation and pay a beneficiary who presents conforming documents even if the issuer's applicant has a right to recover the money paid to the beneficiary in a subsequent suit for breach of warranty.<sup>51</sup>

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guaranty can only be resolved by determination of the rights and obligations of parties to the principal contract or relationship.

HARFIELD, *supra* note 48, at 163–64.

<sup>51</sup>U.C.C. § 5-110 states:

(a) If its presentation is honored, the beneficiary warrants:

- (1) to the issuer, any other person to whom presentation is made, and the applicant that there is no fraud or forgery of the kind described in Section 5-109(a); and
- (2) to the applicant that the drawing does not violate any agreement between the applicant and beneficiary or any other agreement intended by them to be augmented by the letter of credit.

(b) The warranties in subsection (a) are in addition to warranties arising under Articles 3, 4, 7, and 8 because of the presentation or transfer of documents covered by any of those articles.

U.C.C. § 5-110.

The applicant in a commercial letter of credit will most likely always have a direct action against the beneficiary for breach of the underlying contract in cases where the beneficiary has not performed acts necessary to be entitled to an honor of its presentation. *See, e.g.,* Alhadeff v. Meridian on Bainbridge Island, LLC, 220 P.2d 1214, 1221 (Wash. 2009) (citing U.C.C. § 5-110, cmt. 2). The Official Comment to Section 5-110 notes that the warranty under U.C.C. Section 5-110(a)(2) typically applies to standby letters of credit or in those situations where the applicant and the beneficiary are not in a contractual relationship. *See, e.g., id.* at 1222 (noting when there is no contract between the applicant and the beneficiary, there can be no breach of contract claim arising from the underlying transaction, but that the warranties of U.C.C. § 5-110 are available).

The second lynchpin of letters of credit law relates to the extent of compliance of the documents presented to the issuer, obligating it to honor such presentation. The Prior U.C.C. imposed an obligation on the issuer to examine the documents to determine whether they were facially compliant with the terms of the letter of credit.<sup>52</sup> If the “documents appear on their face to comply with the terms of the credit,” the issuer generally had the duty to honor a presentation.<sup>53</sup> The Task Force established to make recommendations for changes to the U.C.C. was critical of these sections primarily because there was no guidance as to the standard of facial compliance.<sup>54</sup> The provision dealing with the compliance of the documents now states that the “issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face *strictly to comply* with the terms and conditions of the letter of credit.”<sup>55</sup> It is important to understand that this strict compliance standard not only applies to the documents that are presented, but also to other terms of the letter of credit, such as time and place for presentation.<sup>56</sup> An Official Comment to this section not only rejects the “substantial compliance” standard that some courts had applied in interpreting the Prior U.C.C. provisions,<sup>57</sup> but also notes that “[s]trict compliance does not mean slavish conformity to the terms of the letter of

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<sup>52</sup> See Prior U.C.C. § 5-109(2).

<sup>53</sup> See Prior U.C.C. § 5-114(2) (noting several exceptions, including a forged or fraudulent document or fraud in the transaction).

<sup>54</sup> See The Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. L. 1521, 1586, 1608–10 (1990) (identifying the two major competing standards used by the courts as “strict compliance” and “substantial compliance”). Section V of this Article describes the work of the Task Force. See also Prior U.C.C. § 5-109, cmt. 2 (noting that the purpose of the obligation to examine documents was “to determine whether the documents appear regular on their face”).

<sup>55</sup> U.C.C. § 5-108(a) (emphasis added). Subsection (e) requires the issuer to “observe standard practice of financial institution that regularly issue letters of credit.” *Id.*

<sup>56</sup> *Id.* § 5-108, cmt. 1.

<sup>57</sup> The Official Comment 1 to U.C.C. § 5-108 cites two cases that the Code drafters believed applied the substantial compliance standard. *Banco Espanol de Credito v. State St. Bank & Tr. Co.*, 385 F.2d 230, 237 (1st Cir. 1967) (holding “that the inspection certificate in this case conformed in *all significant respects* to the requirements of the letter of credit” (emphasis added)); *Flagship Cruises, Ltd. v. New England Merch. Nat’l Bank*, 569 F.2d 699, 705 (1st Cir. 1978) (stating that there was no fatal variance between documents presented and those required by the credit where the issuer would not be misled to its detriment).

credit.”<sup>58</sup> In spite of the Revised U.C.C. provision, compliance disputes concerning the presentation of documents continue to be a significant litigation problem.<sup>59</sup> During the drafting of the letter of credit, the applicant

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<sup>58</sup>U.C.C. § 5-108, cmt. 1 (citing cases establishing that “strict compliance” means less than absolute and perfect compliance). The Comment cited *New Braunfels Bank v. Odiorne*, 780 S.W.2d 313, 318 (Tex. App.—1989, writ denied), where the court held that a draft that was presented, referencing credit 86-122-5, was in compliance with the credit that was number 86-122-S. *Id.* (emphasis added). The second case the Comment approved was *Tosco Corp. v. Fed. Dep. Ins. Corp.*, 723 F.2d 1242 (6th Cir. 1983). In that case, payment was authorized even though the drafts presented stated “No.” instead of Number, used a lower-case “l” instead of a capital “L” in reference to the credit itself, and inserted the state where the bank was located although that was not required in the letter of credit itself. *Id.* at 1247. More recently, a New York court stated that a court’s role in applying the strict compliance rule was merely ministerial, and asserted that to “require [the issuer] to determine the substantiality of the discrepancy would be inconsistent with its function.” *See Ladenburg Thalmann & Co., Inc. v. Signature Bank*, 6 N.Y.S.3d 33, 36 (N.Y. App. Div. 2015) (citing *United Commodities-Greece v. Fid. Int’l Bank*, 478 N.E.2d 172, 174 (N.Y. 1985)). In the *Ladenburg* case, the letter of credit required the presentment of the original of the letter of credit and all amendments. *Id.* at 38. However, the actual presentation included only a copy of one of the amendments, which had subsequently been superseded. In holding that the presentation was in substantial compliance, the court stated:

In the matter before us, there is no possibility that the presentation of a true copy of amendment 2, instead of the original, could mislead defendant to its detriment. Indeed, this copy had been prepared by defendant itself, and was provided to plaintiff by defendant’s own attorney. Its accuracy was not in dispute, and there is no dispute regarding the content of the document, which merely extended the expiration date of amendment 2 and which had since been superseded by subsequent amendments. Since the submission of a true copy of amendment 2 would not compel any inquiry by the bank into the underlying transaction, the rationale for the strict compliance rule, “to protect the issuer from having to know the commercial impact of a discrepancy in the documents,” has no applicability here.

*Id.* at 38–39 (internal citation omitted). *But see Arch Specialty Ins. Co. v. First Cmty. Bank of E. Ark.*, No. 3:15-CV-223-DPM, 2016 WL 4473438, at \*2 (E.D. Ark. Aug. 23, 2016) (noting that presentation of a non-bank verified copy of the letter of credit, when the letter required an original, was not in strict compliance).

<sup>59</sup>*See, e.g., Mago Int’l v. LHB AG*, 833 F.3d 270, 272 (2d Cir. 2016) (presenting an unsigned bill of lading, where the letter of credit required a bill of lading that “[e]videncing shipment of the goods to the applicant” was held not to strictly comply). The Court of Appeals for New York stressed strict compliance in the following language:

We have long adhered to the principle that letters of credit must be strictly construed and performed in compliance with their stated terms. The reason for this rule is rooted in the very purpose of a letter of credit: “[b]y conditioning payment solely upon the terms set forth in the letter of credit, the justifications for an issuing bank’s refusal to honor the

needs to ensure that that the letter of credit specifically lists the documents that need to be presented, what each document needs to recite, and what sort of presentation is required (written, electronic, or otherwise). It is important to note that the issuer receives of minimal fee<sup>60</sup> for its issuance of the letter of credit and it commits only to the ministerial function of quickly confirming whether the presented documents comply with the terms and conditions of the letter of credit.<sup>61</sup>

#### IV. THE FRAUD EXCEPTION TO THE INDEPENDENCE PRINCIPLE

As noted in the Introduction, a New York court in the *Sztejn* case in 1941 judicially introduced the fraud exception into Anglo-American jurisprudence to the then well-recognized independence principle. In *Sztejn*, applying New York law on a motion to dismiss for failure to state a cause of action, the court deemed all the allegations of the plaintiff in the complaint as

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credit are severely restricted, thereby assuring the reliability of letters of credit as a payment mechanism.” Thus, to make an issuing bank’s payment obligation conditional, the parties must clearly and explicitly set forth that requirement on the face of the letter of credit.

*Nissho Iwai Europe PLC v. Korea First Bank*, 782 N.E.2d 55, 59–60 (NY, 2002) (citations omitted). See generally WHITE ET AL., *supra* note 23, at ¶¶26:23–26.30, 212–29 (identifying the various court reported compliance disputes over a period of forty years).

<sup>60</sup>One percent of the amount of the letter of credit is “a fairly standard fee in the industry” for the issuance of the letter of credit for the first year, with an additional fee covering each additional year at an amount less than one percent per year. See *Jaffe v. Bank of Am., N.A.*, No. 07-21093-CIV, 2008 WL 11333769, at \*2 (S.D. Fla. Oct. 10, 2008) (stating that the applicant paid \$60,000 for the issuance of a \$6,030,500 letter of credit and an additional \$88,000 for two years of renewal of the letter of credit).

<sup>61</sup>The U.C.C. provides:

An issuer has a reasonable time after presentation, but not beyond the end of the seventh business day of the issuer after the day of its receipt of documents:

- (1) to honor,
- (2) if the letter of credit provides for honor to be completed more than seven business days after presentation, to accept a draft or incur a deferred obligation, or
- (3) to give notice to the presenter of discrepancies in the presentation.

U.C.C. § 5-108(b).

established.<sup>62</sup> As a result, the court denied the motion to dismiss, as the facts as alleged in the complaint, taken as true, stated a cause of action for injunctive relief.<sup>63</sup> In doing so, the court, in an opinion by Judge Shientag, initially stressed the importance of the independence principle in the following language:

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 controversies between the buyer and the seller regarding the *quality of the merchandise shipped*. *If the buyer and the seller intended the bank to do this they could have so provided in the letter of credit itself* and in the absence of such a provision the court will not demand or even permit the bank to delay paying drafts which are proper in form. Of course, the application of this doctrine presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.<sup>64</sup>

However, in denying the motion to dismiss, the court judicially engrafted an exception to the principle in the following words:

[W]here the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.<sup>65</sup>

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<sup>62</sup>Sztejn v. J. Henry Schroder Banking Corp., 31 N.Y.S.2d 631, 632–33 (N.Y. Special Term 1941) (noting that, under the posture of the case, “every intendment and fair inference is in favor of the pleading” (citations omitted)).

<sup>63</sup>*Id.* at 636.

<sup>64</sup>*Id.* at 633–34 (internal citations omitted) (emphasis added).

<sup>65</sup>*Id.* at 634 (drawing a distinction between a mere breach of warranty concerning the quality of the merchandise and a situation where the seller intentionally fails to ship the goods provided for in the contract). In addressing the issue of fraud versus breach of warranty, the court stated:

Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my



The well-plead allegations in the complaint were taken as established facts supporting a finding of fraud not only in the documents presented,<sup>66</sup> but also in the underlying sales transaction because of the shipping of rubbish as opposed to the contracted-for bristles.<sup>67</sup> The court did assert, however, that if the presentment of the draft had been by a holder in due course, the bank would have honored the presentation, “even though the primary transaction was tainted with fraud.”<sup>68</sup> It is important to note that the judicial recognition

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attention on this point involving an intentional fraud on the part of the seller which was brought to the bank’s notice with the request that it withhold payment of the draft on this account. The distinction between a breach of warranty and active fraud on the part of the seller is supported by authority and reason. As one court has stated: “Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit.”

*Id.* at 634–35 (quoting *Old Colony Tr. Co. v. Lawyers’ Title & Tr. Co.*, 2 Cir., 297 F. 152, 158, *cert. denied* 265 U.S. 585, 44 S. Ct. 459, 68 L. Ed. 1192).

Earlier, the New York Court of Appeals had held that the issuing bank was bound to make payment under a letter of credit if the documents conformed to the credit, “irrespective of whether it knew, or had reason to believe,” that the merchandise was not of the quality that had been contracted for. *See Maurice O’Meara Co. v. Nat’l Park Bank of N.Y.*, 146 N.E.2d 636, 639 (N.Y. 1925) (noting the issuer had no obligation to determine, by personal examination or otherwise, if the merchandise conformed to the sales contract). The court also noted:

It has never been held, so far as I am able to discover, that a bank has the right or is under an obligation to see that the description of the merchandise contained in the documents presented is correct. A provision giving it such right, or imposing such obligation, might, of course, be provided for in the letter of credit.

*Id.*

Judge Cardoza dissented, arguing that if the bank determined that the merchandise delivered was not the same merchandise as the documents described, it should not be compelled to pay the seller. *Id.* at 401. It has been asserted that *Old Colony*’s dictum, relating to the knowledge of the issuer of the fraud, with Cardoza’s strong dissenting opinion in *O’Meara*, that “almost all the bricks and mortar for building the fraud rule were assembled and all that was needed to give birth to the fraud rule was a case like *Sztejn*.” Ross P. Buckley & Xiang Gao, *The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead*, 23 U. PA. J. INT’L ECON. L. 663, 676 (2002).

<sup>66</sup>*Sztejn*, 31 N.Y.S.2d at 632 (noting that the complaint alleged that the documents accompanying the drafts were fraudulent).

<sup>67</sup>*Id.* at 634 (stating that, for purposes of the motion, “it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer”).

<sup>68</sup>*Id.* at 635 (following the holder in due course exception to the fraud rule, even though there was contrary authority).

of the fraud exception and the resultant injunctive relief was based on actual knowledge by the issuer of the fraud by the beneficiary—an event that rarely, in fact, occurs.

The very next year, in *Asbury Park & Ocean Grove Bank v. National City Bank of New York*,<sup>69</sup> Judge Shientag had the opportunity to clarify her holding in the *Sztejn* case. That case involved an underlying sales contract between Silverman and the U.S. Army for the purchase of surplus clothing.<sup>70</sup> Silverman made application to Asbury to issue letters of credit as required in the sales contract to secure payment for the goods.<sup>71</sup> The Army then required additional letters of credit to be issued by other banks, and Asbury was able to get National City to issue those letters of credit.<sup>72</sup> After several years, Asbury requested National City not to honor anymore drafts drawn on its letters of credit, but National City refused the request and continued to honor the presentations under its letters that complied with the terms and conditions of its letters of credit.<sup>73</sup> Asbury's request to National City was based upon an assertion that the beneficiary of the letters of credit and the purchaser of the surplus clothing were using the letters of credits to defraud Asbury.<sup>74</sup> The court noted that, unlike *Sztejn*, there were no allegations that Silverman did not receive the goods or that the goods did not conform to the terms of the contract.<sup>75</sup> The court strongly reinforced the independence principle by clarifying that its earlier fraud exception was limited to “such a fraud on the part of the seller that there were no goods shipped even though shipping tickets were presented.”<sup>76</sup> The court held that:

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<sup>69</sup> 35 N.Y.S.2d 985 (N.Y. Special Term 1942), *aff'd without opinion*, 52 N.Y.S.2d 583 (N.Y. App. Div. 1944).

<sup>70</sup> *Id.* at 987.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* (noting that National City required Asbury Bank to collateralize the letters of credit issued by National City with certain securities).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 988 (alleging that the beneficiary's holding of the drafts and not presenting them for payment until the purchaser failed to pay for the goods was an improper use of the credit and amounted to fraud).

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 988–89 (citing its own *Sztejn* case in support of this statement). In this regard, the court stated:

However, the reasons for the doctrine stated above [the independence principle] apply with greater force to the situation presented in the instant case. The efficacy of the letter

It would be improper to hold up the payment of drafts by the issuing bank [National City] pending the result of such litigation between the correspondent bank [Asbury] and the buyer or seller. Plaintiff's [Asbury] only remedy would be in an action against the Army and Silverman Brothers. It could have protected itself by requiring ample security from Silverman Brothers, or by requiring bills of lading or other documents of title to be presented to the issuing bank as a condition to payment of the drafts.<sup>77</sup>

These two cases clearly establish that the fraud exception, as initially introduced in American jurisprudence, was very limited and was applicable only in the case of a total failure of the beneficiary to perform the underlying sales contract but producing documents that complied with the credit. Other than these two cases, there were essentially no other appellate courts' decisions that expanded the degree of fraud necessary for the application of the fraud exception prior to the promulgation of the U.C.C.<sup>78</sup>

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of credit as an instrument for financing trade is the primary consideration. The contract between the seller and purchaser involves the transaction of trade which calls into being the letter of credit; whereas the correspondent bank's [Asbury Park] contract with the purchaser is merely a collateral financial transaction. If the letter of credit is to be treated as independent of the contract between seller and buyer in order to render it an effective instrument of trade, certainly it must be regarded as completely independent of the contract between the correspondent bank and the purchaser. There was no contract at all between the plaintiff correspondent bank and the seller of the goods, who was the beneficiary of the credits. It therefore follows that a notice given by the 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.

*Id.* at 989.

<sup>77</sup>*Id.* at 989.

<sup>78</sup>*See, e.g.,* HARFIELD, *supra* note 48, at 82, n.18 (stating that the principles enunciated in *Sztejn* were applied in three subsequent cases, including the *Asbury Park* case, with the other two cases decided in 1960 and 1967). *See generally* Chester B. McLaughlin, *The Letter of Credit Provisions of the Proposed Uniform Commercial Code*, 63 HARV. L. REV. 1373, 1378, n.22 (1950) (noting that the proposed fraud exception in the original 1949 draft of the U.C.C. had judicial support, citing only the *Sztejn* and the *Asbury Park* cases). In *Kingdom of Sweden v. N.Y. Tr. Co.*, 96 N.Y.S.2d 779, 790 (N.Y. Special Term 1949), the court cited the *Sztejn* case for the proposition that the issuing bank, absent a requirement in the letter of credit itself, should not go behind the documents to determine whether the goods comported to the sales contract, "unless such documents were *not*

## V. THE U.C.C. AND THE FRAUD EXCEPTION

Like Prior Article 5 of the U.C.C., Revised Article 5 applies equally to both commercial letters of credit and to standby letters of credit.<sup>79</sup> Thus, there are no special U.C.C. rules under Article 5 that apply to one or the other.<sup>80</sup>

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*genuine on their face* or did not conform with the requirements of the letter of credit.” (emphasis added).

<sup>79</sup>See, e.g., BARNES ET AL., *supra* note 39, at 9 (noting that U.C.C. Article 5 applies “one law for all letters of credit”); CRM Collateral, II, Inc. v. TriCounty Metro. Trans. Dist. of Or., 669 F.3d 963, 969 (9th Cir. 2012) (applying Revised Article 5 to a standby letter of credit); Roman Ceramics Corp. v. Peoples Nat’l Bank, 714 F.2d 1207, 1212–16 (3d Cir. 1983) (applying Prior Article 5 to a commercial letter of credit); ACR Sys., Inc. v. Woori Bank, 232 F. Supp. 3d 471, 476–78 (S.D.N.Y. 2017) (applying Revised Article 5 to a commercial letter of credit); Am. Bell Int’l, Inc., v. Islamic Republic of Iran, 474 F. Supp. 420, 424–25 (S.D.N.Y. 1979) (applying Prior Article 5 to a standby letter of credit). See also Revised Article 5, *Prefatory Note: Reasons for Revision*, 2B UNIFORM COMMERCIAL CODE (U.L.A.) 126 (asserting that the increasing use of standby letters of credit since the enactment of the original U.C.C. was a reason for the revision of Article 5 of the U.C.C.) [hereinafter cited as U.C.C. § 5 *Prefatory Note* page number].

<sup>80</sup>While beyond the scope of this Article, there are other regimes that apply to both commercial letters of credit and standby letters of credit. There is the Uniform Customs & Practice for Documentary Credits (UCP 600), which is a codification by the International Chamber of Commerce of the international financial standards used by financial institutions that deal in commercial letters of credit. INT’L CHAMBER OF COMMERCE, UNIFORM CUSTOMS & PRACTICES FOR DOCUMENTARY CREDITS, 2007 REVISION (ICC Pub. No. 600, 2006). Article 1 of the UCP 600 states that it applies to any letter of credit in which it is incorporated, including to the extent possible standby letters of credit. *Id.* art. 1 (stating that the UCP applies to any documentary credit). The ICC is an international business group with members from over 130 countries. See *International Chamber of Commerce*, GLOBAL FORUM ON CYBER EXPERTISE, <https://www.thegfce.com/members-and-partners/members/icc> (last visited Nov. 28, 2018).

However, because of the differences in usage and purpose of standby letters of credit, specific rules in the international context were developed through the Institute of International Banking Law & Practice, Inc. and the International Financial Services Association. See JAMES E. BYRNE, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES xvi–xvii (Inst. Int’l L. & Pract. 1988) (noting that the process included participation of every segment of the letter of credit community). Those rules are found in ISP 98 (International Standby Practices). INTERNATIONAL CHAMBER OF COMMERCE, PUB. NO. 590E (1998). See also JAMES E. BYRNE, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES v (Inst. Int’l L. & Pract. 1988) (stating that the International Chamber of Commerce endorses ISP 98). However, neither the UCP or the ISP have a fraud exception to a demand for honor under a letter of credit. However, the United Nations Commission on International Trade has made an effort to deal with fraud in standby letters of credit. See *United National Convention on Independent Guarantees and Standby Letters of Credit*, UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (1995). See <http://www.uncitral.org/pdf/english/texts/payments/guarantees/guarantees.pdf>. Articles 19 and 20

Both before and after the initial enactment of Prior Article 5 of the U.C.C., there was substantial literature concerning the nature and legal approach to handling letters of credit.<sup>81</sup> One of the issues that was discussed in the literature was how to deal with fraud in the letter of credit transaction, in the underlying contract, or in the documents that were presented to the issuer.<sup>82</sup> The Prior Article 5 contained a provision addressing fraud in the documents and fraud in the transaction and authorizing a court under appropriate circumstances to enjoin payment under a letter of credit.<sup>83</sup> However, the

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of that Convention incorporate a fraud exception to the honoring of standby letters of credit and provide for provisional court measures. *Id.* However, only eight countries have ratified or accepted the convention. Those eight countries are: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, and Tunisia; and although the United States signed the convention in 1997, it has not yet been ratified. See Status: *United National Convention on Independent Guarantees and Standby Letters of Credit* (New York 1995), UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/payments/1995Convention\\_guarantees\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html) (last visited Nov. 28, 2018).

<sup>81</sup>See, e.g., HARFIELD, *supra* note 48; John F. Dolan, *Letter of Credit Litigation Under UCC Article 5: A Case of Statutory Preemption*, 57 WAYNE L. REV. 1269 (2011); Byrne, *supra* note 43; Boris Kozolchyk, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 AM. J. OF COMPARATIVE L. 395 (1965); Norman I. Miller, *Problems and Patterns of the Letter of Credit*, LEGAL PROBLEMS OF INT'L TRADE 162 (1959); A.C. Epps & Harvey Chappell, Jr., *Assimilation of the Letter of Credit by the Common Law*, 38 VIRGINIA L. REV. 531 (1952); Philip W. Thayer, *Irrevocable Credits in International Commerce: Their Legal Nature*, 36 COLUMBIA L. REV. 1031 (1936); William E. McCurdy, *Commercial Letters of Credit*, 35 HARV. L. REV. 539 (1922); Omer F. Hershey, *Letters of Credit*, 32 HARV. L. REV. 1 (1918).

<sup>82</sup>See, e.g., Dolan, *supra* note 4, at 487–90 (arguing for a limited role for the fraud exception); Xiang & Buckley, *supra* note 4, at 298–310 (discussing the various standard the courts used to determine fraud under the Prior Article 5); Buckley & Gao, *supra* note 4, at 681–88 (examining the treatment of the fraud rule under the Prior Article 5 and the Revised Article 5); Edward L. Symons, *Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338, 345–52 (1980) (discussing the various standards that the courts have used in determining whether there is fraud); Henry Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596 (1978) (arguing for an egregious fraud standard).

<sup>83</sup>The pertinent provisions of the original fraud provision in the Prior U.C.C. stated:

Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7–507) or of a security (Section 8–306) or is forged or fraudulent or there is fraud in the transaction:

- (a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft

provision gave little guidance as to the standard of fraud that the courts should use in addressing the problem,<sup>84</sup> or whether fraud in the transaction referred to the underlying transaction or referred merely to the letter of credit transaction.<sup>85</sup> As noted above, some commentators asserted that the *Sztejn*

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or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a security (Section 8-302); and

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

Prior U.C.C. § 5-114(2) (emphasis added). It should be noted that in 1994, the introductory paragraph to Prior U.C.C. § 5-114(2) was amended to reflect the 1994 revisions to Article 8, such that the reference to Section 8-306 was changed to Section 8-108. *Id.*

<sup>84</sup>The Official Comment to the § 5-114 was silent as to the standard of fraud. However, the provision did address the duty of the issuer to honor a presentation, in spite of fraud, where the person making the presentation was similar to an Article 3 holder in due course, or was a person to whom a document of title had been negotiated under Article 7 of the Prior Code, or was a bona fide purchaser of securities under Article 8 of the Prior Code. *See* Prior U.C.C. § 5-114(2)(a). *See also id.* § 5-114, cmt. 2 (noting that, in these situations, the risk of fraudulent actions by the beneficiary should lie with the applicant who chose to enter into the transaction with the beneficiary rather than on innocent third parties or the issuer).

<sup>85</sup>*See* Symons, *supra* note 82, at 368 (stating that, in most transactions, the underlying contract cannot be distinguished from the letter of credit transaction); Dolan, *supra* note 19, at 16–20, n.26 (asserting several arguments for the position that the fraud exception should be limited to fraud in the documents); *Itek Corp. v. First Nat'l Bank*, 730 F.2d 19, 23–25 (1st Cir. 1984) (stating that the fraud exception includes fraud in the underlying transaction); *W. Va. Hous. Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1114 (W.D. Pa. 1976) (limiting the fraud inquiry to the credit transaction). *See also* Dolan, *supra* note 4, at 88–89 (arguing that courts should confine their investigation of fraud to the letter of credit transaction). In this article Professor Dolan admitted that his efforts to limit the fraud inquiry had been largely unsuccessful. *Id.* (noting the Official Comment in the Revised Article § 5-109, making it quite clear that the fraud inquiry may include inquiry into the underlying transaction).

*See also* Prior U.C.C. § 5-114, cmt. 2 (stating merely that the applicant bore the risk of fraud in the transaction). Prior to 1957, the fraud rule appeared in §§ 5-111(1), (2) and was limited in application to “fraud in a required document.” *See* 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 201, *reprinted in* XVIII THE AMERICAN LAW INSTITUTE & NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE: DRAFTS (compiled by E. Kelley 1984). The recommendations of the Editorial Board were to move the fraud section to Article 5-114(2) and to add additional language concerning “fraud in the transaction.” *Id.* at 204–05. The reason given for the recommended change was

case was codified in Prior Article 5.<sup>86</sup> However, even that case gave little guidance on the standard of fraud. In fact, it merely held that an intentional failure to ship any goods that were the subject of the underlying sales contract would be a fraudulent transaction.<sup>87</sup> Furthermore, the case law interpreting the fraud provision of Prior § 5-114(2) was not consistent, as the courts used differing standards to determine whether there was fraud either in the documents or transaction. These standards included egregious fraud,<sup>88</sup>

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“[s]ubsection (2) clarifies by cross-reference the intent of old Section 5-111(1) and (2).” *Id.* at 205. The 1957 Official Text of the U.C.C. adopted the recommendations and included both “fraud in a document” and “fraud in the transaction” in the new Section 5-114(2). *See* UNIFORM COMMERCIAL CODE: 1957 OFFICIAL TEXT WITH COMMENTS (THROUGH ARTICLE 6) 449–450, *reprinted in* XIX THE AMERICAN LAW INSTITUTE & NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE: DRAFTS (compiled by E. Kelley 1984).

<sup>86</sup>*See, e.g.*, Xiang & Buckley, *supra* note 4, at 298 (stating that the *Sztejn* case was codified in the Prior Article 5); Buckley & Gao, *supra* note 4, at 676 (asserting that not only has the *Sztejn* case been codified in the UCC, but it “has been cited with approval and followed throughout the common law world”); Symons, *supra* note 82, at 340 (noting that “[t]he section 5-114 standard is generally acknowledge to be a codification of the leading pre-Code case”). *See also* John F. Dolan, THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS ¶7.04[3], 7–38 (2d ed. 1991) (stating that Section 5-114(2) of the Prior U.C.C. codified the *Sztejn* rule).

<sup>87</sup>*Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631, 634–35 (N.Y. Special Term 1941) (citing the *Old Colony* case for the additional proposition that when an issuer knows that a document present was false or illegal, the issuer has no obligation to honor the presentation).

<sup>88</sup>*See, e.g.*, *N.Y. Life Ins. Co. v. Hartford Nat'l Bank & Tr.*, 378 A.2d 562, 567 (Conn. 1977) (noting that the prior fraud provision applied in rare situations of egregious fraud that would vitiate the transaction); *Intraworld Indus., Inc. v. Girard Tr. Bank*, 336 A.2d 316, 324–25 (Pa. 1975) (holding that the fraud required had to so vitiate “the entire transaction that the legitimate purposes of the independence of the issuer’s obligation would no longer be served”); *GATX Leasing Corp. v. DBM Drilling Corp.*, 657 S.W.2d 178, 182 (Tex. App.—San Antonio 1983, no writ) (stating that it took egregious fraud to obtain an injunction under the Prior Article 5).

intentional fraud,<sup>89</sup> a flexible standard,<sup>90</sup> or common law fraud.<sup>91</sup> One of the reasons for so many divergent views on what constituted fraud was the “slippery character of fraud in U.S. jurisprudence.”<sup>92</sup> In addition, as Section 5-114(2) gave no guidance as to what the requirements were for injunctive relief,<sup>93</sup> the “courts typically applied the forum’s general test for issuance of injunctive relief.”<sup>94</sup> This lack of uniformity in the standard of fraud, the scope of fraud, and in the standards for injunctive relief revealed critical weaknesses in letters of credit jurisprudence, lessening their usefulness as viable instruments in international trade.<sup>95</sup>

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<sup>89</sup> See, e.g., *Aetna Life & Cas. v. Huntington Nat’l Bank*, 934 F.2d 695, 702 (6th Cir. 1991) (noting that it was not necessary for the court to determine if the requirements of common law fraud had been met because the issuer in a case of fraud in the transaction must only show intentional fraud (citing *Allservices Exportacao v. Banco Bamerindus*, 921 F.2d 32, 35 (2d Cir. 1990)); *Am. Bell Int’l v. Islamic Republic of Iran*, 474 F. Supp. 420, 425 (S.D.N.Y. 1979) (noting that the beneficiary had failed to demonstrate “the kind of evil intent necessary to support a claim of fraud”).

<sup>90</sup> Several decisions attempted to look at the circumstances of the situation and drew a distinction between breach of warranty and outright fraud, as the court did in the *Sztejn*. See, e.g., *Philipp Bros., Inc. v. Oil Country Specialist, Ltd.*, 709 S.W.2d 262, 265 (Tex. App.—Houston [1st Dist.] 1986, writ dismissed) (finding that the substandard condition of the oil field pipe was pervasive enough to render the entire inventory worthless and constituted fraud, not a mere breach of contract); *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 360 N.E.2d 943, 949 (N.Y. 1976) (finding that fraud in the transaction, similar to the *Sztejn* case, occurred when the delivered merchandise comprised fragments of boxing gloves rather than real boxing gloves).

<sup>91</sup> See *WKB Enter. v. Ruan Leasing Co.*, 838 F. Supp. 529, 533 (D. Utah 1993) (holding that the applicant for the letter of credit was not entitled to injunctive relief in part because he failed to prove that the issuer had relied on the misrepresentation); *Brown v. U.S. Nat’l Bank of Omaha*, 371 N.W.2d 692, 699 (Neb. 1985) (holding that “the material elements of common-law fraud must be established before any relief is available for the ‘fraud’ contemplated by Section 5-114(2)” (citation omitted)).

<sup>92</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1614–15 (noting that fraud under the U.C.C. does not need to rise to the level of criminal fraud as in many civil law jurisdictions).

<sup>93</sup> See Prior U.C.C. § 5-114(2) (providing merely that a court could enjoin an honor).

<sup>94</sup> See The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1610–11 (noting that although the courts generally weighed factors, such as probability of success, irreparable injury, private and public interest, the decisions cited by the Task Force varied on which factor was more important).

<sup>95</sup> The Task Force on the Study of U.C.C. Article 5 stated the following about the fraud exception:

The most critical facet of letter of credit law, the availability of injunctive relief in the case of fraudulent conduct as an exception to the requirement to honor facially



In 1986,<sup>96</sup> the U.C.C. Committee of the American Bar Association appointed a Task Force of knowledgeable practitioners and academicians to recommend changes to Article 5.<sup>97</sup> After the Task Force had made extensive review of the case law and the evolving technologies and changes in customs and practices, it made significant recommendations for revisions to Prior Article 5.<sup>98</sup> In its *Prefatory Note: Reason for Revision* the Task Force stated:

[A]lmost forty years of hard use have revealed weaknesses, gaps, and errors in the original statute which compromise its relevance . . . .

Measured in terms of these areas which are vital to any system of commercial law, the current combination of statute and case law is found wanting in major respects both in predictability and certainty. What is at issue here are not matters of sophistry but important issues of substance which have not been resolved by the current caselaw/code method and admit of little likelihood of such resolution.<sup>99</sup>

With regard to the fraud provision, the Task Force concluded that U.S. trial judges issued too many injunctions preventing issuers from honoring credits, and therefore it recommended the preparation of a written commentary to the fraud provision clarifying the bases for the issuance of injunctive relief.<sup>100</sup> With respect to the proper standard for fraud, the Task

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conforming documents, has proven to be a threatening cancer. What warrants injunctive relief is unclear as is the scope of fraud—potentially so broad under U.S. common law as to encompass conduct in which there is no element of intent—and the mechanisms by which relief is to be granted.

The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1534.

<sup>96</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1527.

<sup>97</sup> See U.C.C. § 5, *Prefatory Note: Reason for Revision* 127.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1612. The Report of the Task Force stated:

Interlocutory relief which prevents payment following presentment or, worse, which forces the beneficiary to litigate in a distant court is tolerable only if as a threshold consideration a court has concluded that the demand is probably forged or fraudulent and

Force suggested a “narrowly gauged standard” alerting the courts and the parties that “not just any fraud will suffice.”<sup>101</sup> Some members of the Task Force also suggested adding a commentary to the fraud provision with a list of approved and disapproved cases.<sup>102</sup> However, others members proposed rewriting the entire provision “in light of the increasing desirability of harmonization with other legal systems.”<sup>103</sup> In its final report the Task Force proposed a stringent standard of fraud to prevent the reallocation of risks that had been agreed upon by the parties to the underlying transaction.<sup>104</sup>

Following the Task Force’s Report, the Drafting Committee, after consultation and discussions with various groups including the Task Force<sup>105</sup> adopted the following fraud provision:

(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially

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has imposed conditions on the maintenance of preliminary injunctive relief that will deter the plaintiff from falsely claiming forgery or fraud.

The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1612. *See also* MCCULLOUGH, *supra* note 47, at 61 (stating that “[p]erhaps no other subject has generated as much litigation regarding letters of credit as that of the injunction against honor”).

<sup>101</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1615. The Task Force, realizing that the formulation of a fraud standard was difficult, wrote as follows:

The term “fraud in the transaction”, at least, has the advantage of familiarity. “Egregious” fills a void in the current term regarding the requisite degree of fraud although it is hardly precise. Another approach is to focus on the notion that the purpose of the underlying transaction must be rendered virtually without value for an injunction to issue. This approach may be less helpful in the case of standbys where a default occasions the drawing. For standbys, the focus would be on whether the drawing has occurred with no colorable basis whatsoever.

The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1615.

<sup>102</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1615.

<sup>103</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1616 (noting that European cases in the area of forged or fraudulent documents had concluded that fraud was more than a mere misstatement).

<sup>104</sup> The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1617 (noting also that injunctive relief “invites parties and courts to undermine the integrity of the credit by an end run”).

<sup>105</sup> U.C.C. § 5, *Prefatory Note: Reasons for Revision* 127 (noting that the Drafting Committee’s final work varied from many of the suggestions of the Task Force); U.C.C. § 5, *Prefatory Note: Process of Achieving Uniformity* 128 (summarizing the various meetings of the Drafting Committee and the consultation process of that Committee).

fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

(1) the issuer shall honor the presentation if honor is demanded by:

(A) a nominated person who has given value in good faith and without notice of forgery or material fraud;

(B) a confirmer who has honored its confirmation in good faith;

(C) a holder in due course of a draft drawn under the letter of credit that was taken after acceptance by the issuer or nominated person; or

(D) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:

(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;

(2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;

(3) all of the conditions to entitle a person to the relief under the law of this state have been met; and

(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under Subsection (a)(1).<sup>106</sup>

The Revised Article 5 adopts “material fraud” as the fraud standard, but the provision does not define the term, leaving that issue to the courts.<sup>107</sup> However, the Official Comment refers to various articulations found in cases that identify what actions would amount to material fraud.<sup>108</sup> The listed articulations include: no colorable right to expect honor;<sup>109</sup> no basis in fact to support honor;<sup>110</sup> the beneficiary’s conduct vitiates the entire transaction;<sup>111</sup> and the underlying contract plainly establishes that the beneficiary has no right to draw on the letter of credit.<sup>112</sup> The fraud provision also makes it clear that the material fraud must either be found in the documents or have been

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<sup>106</sup>U.C.C. § 5-109.

<sup>107</sup>*See id.* at cmt. 1 (leaving it to the courts to “decide the breadth and width of ‘materiality’”). The Official Comment does, however, give an example of a sales contract for 1,000 barrels of salad oil and states that an invoice for 1,000 barrels when only 998 barrels were delivered would not be materially fraudulent, but a knowing delivery of only 5 barrels and presenting an invoice showing 1,000 barrels would be materially fraudulent. *Id.*

<sup>108</sup>*Id.* (indorsing articulations such as those stated in *Intraworld Indus. v. Girard Trust Bank*, 336 A.2d 316 (Pa. 1975), *Roman Ceramics Corp. v. People’s Nat. Bank*, 714 F.2d 1207 (3rd Cir. 1983), and similar decisions and embracing certain decisions under Section 5-114 that relied upon the phrase “fraud in the transaction”).

<sup>109</sup>*See Itek Corp. v. First Nat’l Bank of Boston*, 730 F.2d 19, 24 (1st Cir. 1984) (holding that an injunction would lie to prevent the honoring of a presentation where the beneficiary “did not even have a colorable claim”).

<sup>110</sup>*See Dynamics Corp. of Am. v. Citizens & S. Nat’l Bank*, 356 F. Supp. 991, 999 (N.D. Ga. 1973) (noting that the court’s task was simply assuring that the beneficiary “not be allowed to take unconscientious advantage of the situation and run off with plaintiff’s money on a *pro forma* declaration which has absolutely no basis in fact”); *Intraworld*, 336 A.2d at 325 (noting that an injunction to prevent the honoring of a presentation would be proper when the beneficiary had “no bona fide claim to payment”).

<sup>111</sup>*See Intraworld*, 336 A.2d at 324–25 (stating that the grounds for issuance of an injunction should be narrowly limited to those situations where the fraud of the beneficiary “so vitiates the entire transaction that the legitimate purposes of the independence of the issuer’s obligation would no longer be served”).

<sup>112</sup>*See Itek*, 730 F.2d at 24 (noting that the fraud exception “recognizes the unfairness of allowing a beneficiary to call a letter of credit under circumstances where the underlying contract plainly shows that he is not to do so”).

committed by the beneficiary on the issuer or the applicant.<sup>113</sup> Finally, in response to the Task Force's Recommendation,<sup>114</sup> the new provision spells out the specific requirements for the granting of injunction relief.<sup>115</sup>

The revised fraud provision immunizes four parties from the risks of fraud, and the issuer must honor their presentation that strictly conforms to the terms and conditions of the letter of credit even if "a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant."<sup>116</sup> The protected parties are:

- (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person . . . .<sup>117</sup>

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<sup>113</sup>U.C.C. § 5-109, cmt. 1 (citing *Cromwell v. Commerce & Energy Bank*, 464 So.2d 721 (La. 1985)).

<sup>114</sup>*See* The Task Force on the Study of U.C.C. Article 5, *supra* note 54, at 1612 (noting the need for the fraud provision to "spell out the basis on which temporary restraining orders and preliminary injunctions should or should not be issued").

<sup>115</sup>*See* U.C.C. § 5-109(b) (providing generally that an injunction will lie to enjoin the honoring of a presentation if the conditions of state law for the entry of an injunction are met, the applicant is more likely than not to succeed on his claim of fraud or forgery, and the interest of the parties who may be adversely affected are adequately protected).

<sup>116</sup>*Id.* § 5-109(a)(1). There is no equivalent protection in negotiable instruments law, where the holder in due course is only protected against personal defenses, but not the real defenses one of which is fraud "that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms." *Id.* § 3-305(a)(1), (b).

<sup>117</sup>*See* U.C.C. § 5-109(a)(1). The Official Comment relating to this specific section is short and concise:

Section 5-109(a)(1) also protects specified third parties against the risks of fraud. By issuing a letter of credit that nominates a person to negotiate or pay, the issuer (ultimately the applicant) induces that nominated person to give value and thereby assumes the risk

The first two protect parties are nominated persons acting pursuant to their respective nomination. Thus, a nominated person who gives value in good faith<sup>118</sup> without notice<sup>119</sup> of forgery or material fraud is entitled to be reimbursed,<sup>120</sup> as well the nominated person who is a confirmer who acts in good faith without the requirement of giving value<sup>121</sup> or not having notice of the fraud by the beneficiary.<sup>122</sup> Thus, a confirmer who honors its confirmation

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that a draft drawn under the letter of credit will be transferred to one with a status like that of a holder in due course who deserves to be protected against a fraud defense.

U.C.C. § 5-109, cmt. 6. Some of these immunized persons are similar to those protected against the fraud exception in Prior Article 5. *See* Prior U.C.C. § 5-114(2)(a).

<sup>118</sup>Good faith is defined for purposes of Revised Article 5 as “honesty in fact in the conduct or transaction concerned.” U.C.C. § 5-102(a)(7). The general definition of good faith that is applicable to the other articles of the U.C.C. includes not only honesty in fact but “observances of reasonable commercial standards of fair dealing.” *Id.* § 1-201(20) (noting specifically that this expansive definition does not apply in Chapter 5). *See also Id.* § 5-102(a)(7), Official Comment 3 (stating that Article 5 has a narrower definition of good faith than other Articles of the U.C.C.).

<sup>119</sup>As notice is not defined in Revised Article 5, the definition in Revised Article 1 applies. *See Id.* § 5-102(c) (stating that Article 1 of the U.C.C. contains some additional definition that are applicable throughout Revised Article 5). U.C.C. § 1-202(a), (b) states, in relevant part:

(a) . . . , a person has “notice” of a fact if that person:

- (1) has actual knowledge of it;
- (2) has received a notice or notification of it; or
- (3) from all the facts and circumstances known to the person at the time in question, has reason to know that it exists.

(b) “Knowledge” means actual knowledge. “Know” has a corresponding meaning.

U.C.C. § 1-202(a), (b).

<sup>120</sup>U.C.C. § 5-109(a)(1)(i) (noting that a nominated person can avoid the fraud exception by giving value in “good faith without notice of forgery or material fraud”). A nominated person is typically designated in those situations where the issuer and the beneficiary operate in different locations, and the beneficiary might desire to obtain payment from a local financial institution. *See Dole, supra* note 22, at 743.

<sup>121</sup>*See* Byrne, *supra* note 48, at 586 (stating that when the confirmer gives its irrevocable promise there is no question of value).

<sup>122</sup>The confirmer “is directly obligated on a letter of credit and has the rights and obligations of an issuer to the extent of its confirmation.” U.C.C. § 5-107(a) (treating the interrelationship between the two just as if the issuer were the applicant and the confirmer had issued the letter of credit). Official Comment 1 to U.C.C. § 5-108 notes that the confirmer has the same rights and duties of an issuer.

in good faith is entitled to reimbursement even though he was notified of alleged material fraud.<sup>123</sup>

The last two immunized persons do not necessarily need to be nominated persons and involve situations of delayed payment.<sup>124</sup> The first of these is the situation of a holder in due course of accepted time drafts drawn under the letter of credit after their acceptance<sup>125</sup> by the issuer or a nominated person.<sup>126</sup> In a typical letter of credit transaction involving a time draft, the issuer or confirmer will accept the beneficiary's written order for payment (typically a time draft) in a certain number of days after a designated date. Once the time draft is accepted, any holder in due course of that draft is immune from the fraud exception. The protection of this person rests not only on him being a holder in due course, but upon the fact that he has acquired rights from either the issuer or confirmer to an irrevocable obligation to pay. Thus, if the issuer accepts a time draft drawn on the letter of credit, then any holder in due course of that draft is immunized against an assertion of fraud defense when the accepted draft is presented for payment.

The last immunized person is an assignee of the issuer's or nominated person's deferred obligation taken for value and without notice of forgery or

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<sup>123</sup>Dole, *supra* note 22, at 753 (noting the distinction between the confirmer and the other immunized persons).

<sup>124</sup>These final two sources of immunity highlight the distinction between a negotiation credit and a straight letter of credit. While the U.C.C. does not define either of these terms the law clearly recognizes them. *See* Dole, *supra* note 22, at 764–68 (differentiating between the straight letter of credit and the negotiation credit). To be a negotiation credit the “letter of credit must contain both a clear undertaking by the issuer to reimburse a nominated negotiation bank that has negotiated and a clear indication of the bank or banks nominated to negotiate.” *Id.* at 765 (citing a New York Court of Appeals decision that involved an express engagement in the letter of credit to honor drafts presented by a negotiating bank who had purchased the signed drafts of the beneficiary). A straight letter of credit contains only a commitment by the issuer to honor a demand for payment by the beneficiary upon its performance of the terms and conditions of the credit. *See* MCCULLOUGH, *supra* note 47, at 100 (stating such a letter contains no commitment to any person other than the named beneficiary). Thus, if the letter of credit is a straight letter of credit a bank that purchases the drafts of the beneficiary is not protected claims of fraud, and in effect is no better off than the beneficiary. *See* WHITE ET AL., *supra* note 23, at 261.

<sup>125</sup>While Revised Article 5 does not contain a definition of accept or acceptance, it does state that the definition in U.C.C. § 3-409 applies in this article. U.C.C. § 5-102(b). U.C.C. § 3-409(a) provides that ““acceptance”” means the drawee's signed agreement to pay a draft as presented. It must be written on the draft and may consist of the drawee's signature alone.” Thus, once the issuer or confirmer accepts the draft by signing the draft, it becomes obligated to pay the draft.

<sup>126</sup>U.C.C. § 5-109(a)(1)(iii).

material fraud after the obligation was incurred by the issuer or nominated person.<sup>127</sup> A deferred payment obligation is an obligation that is contained in the letter of credit itself undertaking to make payment a set number of days after the presentation of conforming documents.<sup>128</sup> In this latter case, the issuer or confirmer has unconditionally undertaken to pay the deferred obligation at a later date.<sup>129</sup> Thus, an assignee of that obligation has a clear right to expect payment.<sup>130</sup> While the confirmer need only satisfy the requirement of good faith,<sup>131</sup> the other three immunities arise only in the case of good faith without notice of forgery or material fraud.<sup>132</sup>

It should be clear from the preceding discussion that there are certain limitations to the application of the fraud exception in letters of credit law to protect certain parties. Thus, in letters of credit law, fraud, although abhorred, is often overlooked for the protection of certain immunized persons such that fraud does not always unravel the entire transaction. In each of these cases, there are valid and acceptable policy reasons for requiring the independence principle to exercise its true commercial role and to be untethered from the fraud rule.

## VI. POLICY JUSTIFICATIONS FOR THE FRAUD EXCEPTION

The fraud rule turns the unconditional undertaking of the issuer into a conditional undertaking dependent upon the underlying contract. The condition that it imposes on that undertaking in a typical commercial credit situation is that the issuer can honor a strictly complying presentation, if and

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<sup>127</sup> *Id.* § 5-109(a)(1)(iv).

<sup>128</sup> A deferred payment letter of credit typically requires that the specified documents be presented on a specified date and provides that payment will be made at some future date. *See* MCCULLOUGH, *supra* note 47, at 94. *See, e.g.*, *First Union Bank v. Paribas*, 135 F. Supp. 2d 443, 446 (S.D.N.Y. 2001) (involving letters of credit providing for payment 180 days after the presentation of documents).

<sup>129</sup> *See id.*

<sup>130</sup> *See* BARNES ET AL., *supra* note 39, at 58 (1998) (stating that letter of credit policy “favors protection of those who rely on the LC proceeds that are created when honor is initiated”).

<sup>131</sup> *Compare* U.C.C. § 5-109(a)(1)(ii) (noting that a confirmer need only have honored its confirmation in good faith), *with id.* § 5-109(a)(1)(i) (noting that a nominated person must give value in good faith and without notice of the fraud or forgery).

<sup>132</sup> *See id.* § 5-109(a)(1)(i) & (iv) (stating those requirements explicitly; while U.C.C § 5-109(a)(iii) immunity requires qualification as a holder in due course). *See also id.* § 3-302(a) (2) (requiring a holder in due course of a negotiable instrument to acquire it in good faith and without notice of a claim or defense).



only if, the underlying contract between the applicant and the beneficiary has not been materially breached. Thus, for example, where the merchandise is never shipped or fails to comply in any respect to the contracted-for merchandise, the issuer can be enjoined from honoring the presentation even if the documents strictly comply. The condition that the fraud rule imposes on the typical standby credit is that the issuer can honor a strictly complying presentation, if and only if, the underlying contract between the applicant and the beneficiary has not been breached. The imposition of these conditions for honoring a presentation strips the beneficiary of the bargain that he contracted for.<sup>133</sup> The imposition of these conditions for honoring a presentation breaches the issuer's undertaking to the beneficiary to honor a

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<sup>133</sup>Professor Dolan summarized the harm to the beneficiary when the independence principle was compromised by a fraud inquiry in the following words:

[A]nd sometimes at the close of the [fraud] inquiry the court may decide that there is no fraud. By then it is too late to protect the beneficiary, who has lost his bargain, and too late to protect the credit, which is no longer a unique device but only another kind of bond. Even if the court finds at the end of that inquiry that there is fraud, the process has occurred in a forum and under circumstances contrary to the bargain the parties struck. In addition, the account party, after enjoying the fruits of the credit *ex ante*, has avoided the cost of litigating without the funds in the beneficiary's forum.

Dolan, *supra* note 19, at 15–16.

The Supreme Court of Alabama explained the benefits of the standby letter of credit to the beneficiary in the following words:

The beneficiary of the standby credit reasonably expects to receive payment from the issuer promptly upon demand and before any litigation between the applicant and the beneficiary may occur. . . . A demand for payment made upon a standby credit usually indicated that something has gone wrong in the contract. Indeed, this is the nature of the standby letter of credit. In contrast to the commercial credit nonperformance that triggers payment in a standby credit situation usually indicates some form of financial weakness by the applicant. For this reason parties choose this security arrangement over another so they have the benefit of prompt payment before any litigation occurs.

S. Energy Homes, Inc. v. AmSouth Bank of Ala., 709 So. 2d 1180, 1184–85 (Ala. 1998) (citations omitted). *See e.g.*, Dolan, *supra* note 4, at 502 (noting that the courts need to resist efforts to reorder the letter of credit transaction “ex post from a pay-now-argue-later regime to an argue-now-pay-later regime”). Professor Dolan noted that the applicant should seek his remedy against the beneficiary where he must pay the costs and assume the risks he undertook when it asked the bank to issue the independent obligation. *Id.* *See also* Eakin v. Cont'l Ill. Nat'l Bank & Tr. Co. of Chi., 875 F.2d 114, 116 (7th Cir. 1989) (stating that the promise and premise of letters of credit law are “pay now, argue later”).

proper presentation pursuant to the independence principle and imposes litigation time, and possible money and expenses, upon the issuer that were not part of any contract or undertaking the issuer agreed to.<sup>134</sup>

However, it has been asserted that “[t]he idea that fraud upsets the usual rules of credits is an old one.”<sup>135</sup> Rarely, if ever, have the courts given specific

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<sup>134</sup>There is no doubt that the reimbursement agreement can contractually obligate the applicant to reimburse the issuer for attorney’s fees and expenses in any litigation that might arise under the letter of credit. Furthermore, U.C.C. § 5-111(e) states: “[r]easonable attorney’s fees and other expenses of litigation must be awarded to the prevailing party in an action which a remedy is sought under the article.” U.C.C. § 5-111(e). Official Comment 6 to U.C.C. § 5-111(e) states that an issuer can be a prevailing party, although this would normally arise in those situations where it dishonored a presentation and was successful in a subsequent suit by the beneficiary seeking payment. Furthermore, this Comments states, “[s]ince the issuer may be entitled to recover its legal fees and costs from the applicant under the reimbursement agreement, allowing the issuer to recover those fees from a losing beneficiary may also protect the applicant from undeserved losses.” *Id.* cmt. 6.

<sup>135</sup>Buckley & Gao, *supra* note 4, at 669 (stating that “Pillans planted the seed of the fraud rule at a time when letters of credit were barely born.”) (citing DOLAN, *supra* note 25, at ¶ 7.03[1], 76, 76 n.22 (citing two English case—*Pillans v. Van Mierop* and *Mason v. Hunt*)). *Pillans & Rose v. Van Mierop & Hopkins*, 97 Eng. Rep. 1035, 1037 (K.B. 1765), involved a letter of credit. In that case, plaintiffs extended credit to White, an Irish merchant. *Id.* at 1035. As a condition for accepting drafts from White, plaintiffs desired an irrevocable letter of credit from a “house of Rank in London.” *Id.* White named defendants’ house and plaintiffs honored White’s drafts and paid the money over to White. *Id.* Plaintiffs then wrote defendants asking them whether they would accept bills as they would draw upon the credit of White. *Id.* Having received written assent “that they would honour the plaintiffs’ draughts,” they drew on defendants. *Id.* at 1038. However, as White had become bankrupt, defendants refused to honor the bills. *Id.* at 1035. The trial court held for defendants pursuant to a verdict. *Id.*

On appeal, Lord Mansfield believed the defendants “were bound by their letter; unless there was some fraud upon them,” noting they had undertaken a mercantile transaction “to give credit for Pillans and Rose’s reimbursement.” *Id.* at 1036. However, he saw no fraud. *Id.* On re-argument the defendants asserted that there was a “fraudulent concealment of facts”—specifically that the plaintiffs and White concealed the fact that this transaction was not for a future credit but was to secure the past acceptance of White’s bills by the plaintiffs establishing that the plaintiffs doubted White’s financial capabilities. *Id.* at 1037. In rejecting that argument Lord Mansfield stated, “If there was *any kind of fraud* in this transaction, the collusion and mala fides would have vacated the contract. But from these letters, it seems clear, that there was none.” *Id.* at 1038 (emphasis added) (noting that there was no evidence that the plaintiffs doubted White’s financial sufficiency). The case in a broad sweep states “any kind of fraud” in the transaction can vacate the obligation of the issuer to honor its letter of credit. However, in the case there were only allegations of fraud in the issuance of the letter of credit, and no allegations of fraud in the payment of the letter of credit. The alleged fraud was in the letter of credit formation and was perpetrated by the applicant or the applicant and the beneficiary in collusion with each other.

reasons for the fraud exception to the independence principle in letters of credit law.<sup>136</sup> Instead, the courts refer to the beneficiary as “unscrupulous,”<sup>137</sup> or “dishonest,”<sup>138</sup> or describe the fraud sufficient to invoke the equitable powers of the court as “egregious”<sup>139</sup> or “intentional.”<sup>140</sup>

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The other case cited as authority for the birth of the fraud exception was *Mason v. Hunt*, 99 Eng. Rep. 192 (K.B. 1779). Although not a letter of credit case, the *Mason* case does raise the specter of fraud as a justification for excusing a promisor from the obligation to accept a bill of exchange. In that case there was an agreement to accept and pay bills of exchange for the purchase of prize tobacco. *Id.* at 192. The agreement to accept the bills specifically stated that a “certain number of hogsheads to be delivered—of a certain value rated by the hogshead.” *Id.* at 194. The tobacco that was delivered was of inferior French island tobacco which was worth substantially less than the purchase price in the agreement. *Id.* The endorsee of the bills of exchange sought payment of the full amount of the bills. *Id.* at 192. The case was tried before Lord Mansfield and a verdict was rendered for the defendants. *Id.* at 193. A rule for a new trial was obtained, but after argument it was discharged. *Id.* at 194. Lord Mansfield believed the great difference in value of the tobacco “is such a fraud as to entitle the defendants to relief against the agreement.” *Id.* However, the court did not determine whether there had been fraud as there was no evidence as to how the decrease in value occurred. *Id.* at 194. The court noted that the endorsee took the bills and was aware of the conditions as to quality and was bound by the terms of the agreement. *Id.* However, the grounds given for the inability to recover was not based on fraud, but on the fact that the endorsee had signed an agreement that he would take the bills of lading and sell the tobacco for his own account in part payment of the bills of exchange. *Id.* The court noted that defendants would not have accepted the bills without the security of the goods and the insurance which remained with the endorsee. *Id.* See also *Coolidge v. Payson*, 15 U.S. 66, 73 (1817) (Marshall, C.J.) (observing that “[a]ny ingredient of fraud” would affect the obligation of the issuer to honor a presentation).

<sup>136</sup> *Supra* note 134.

<sup>137</sup> See, e.g., *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631, 634 (N.Y. Special Term 1941) (stating that the issuer’s obligation under the independence principle should not be extended to protect an unscrupulous beneficiary). See also *Buckley & Gao*, *supra* note 4, at 665 (referring to the beneficiaries who present forged or fraudulent documents as fraudsters).

<sup>138</sup> See, e.g., *United City Merch. v. Royal Bank of Can.*, 1 A.C. 168, 184 (1983) (stating the “[t]he exception of fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi cause non oritur actio*, or, if plain English is to be preferred, ‘fraud unravels all.’ The courts will not allow their process to be used by a dishonest person to carry out the fraud.”).

<sup>139</sup> See, e.g., *N.Y. Life Ins. Co. v. Hartford Nat’l Bank & Tr.*, 378 A.2d 562, 567 (Conn. 1977) (stating that the fraud provision applied in rare situations of egregious fraud that would vitiate the transaction).

<sup>140</sup> See, e.g., *Aetna Life & Cas. v. Huntington Nat’l Bank*, 934 F.2d 695, 702 (6th Cir. 1991) (holding that it was not necessary for the court to determine if the requirements of common law fraud had been met because in a case of fraud in the transaction one must only show intentional fraud).

A review of the literature establishes that the major policy justifications for the fraud exception are four-fold, but interrelated: (1) a total disdain for letting a fraudster obtain funds from the issuer; (2) concern that fraudulent payments under the credit will diminish the viability of the letter of credit in commercial transactions; (3) possible financial difficulties for the applicant; and (4) fraudulent payments by an issuer could diminish the reputation of the issuer. While there is clearly a public interest in protecting the applicant and the issuer from a beneficiary's fraud, this interest should be balanced with the commercial and financial interest in maintaining the issuer's independent obligation under the credit. This Article will now undertake to briefly evaluate these policy justifications that tether the fraud inquiry to limit the independence principle and then will propose new and different ways to achieve these policy objectives without reliance on the fraud exception.

Some commentators assert that there is a loophole in letters of credit law.<sup>141</sup> The loophole arises as a function of the operation of the independence principle as an absolute assurance of payment to a beneficiary upon presentation of conforming documents.<sup>142</sup> Thus, under the independence principle, a beneficiary who knowingly presents fraudulent documents that strictly comply with the terms and conditions of the credit or fails to perform his underlying contractual obligations will be paid by the issuer. These commentators argue that the fraud exception is the way to close that loophole by authorizing a court to go beyond the documents presented to ascertain whether there is any material fraud in the documents or the underlying

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<sup>141</sup>See, e.g., Buckley & Gao, *supra* note 4, at 664–65 (stating that “[t]he separation in law of the documents from the actual performance of the underlying transaction is absolutely necessary for credits to fulfill their essential commercial function and creates a loophole for unscrupulous beneficiaries to abuse the system”); Gao, *supra* note 41, at 56 (arguing that since all a beneficiary has to do was produce facial compliant documents there was a loophole for the unscrupulous to defraud others).

<sup>142</sup>The Canadian Supreme Court expressed the obvious dilemma created by the fraud exception as follows:

The potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions; at the same time the application of the principle of autonomy must not serve to encourage or facilitate fraud in such transactions.

Bank of Nov Scotia v. Angelica-Whitwear Ltd., D.L.R. 161, 168 (Can. 1987).

transaction.<sup>143</sup> Underlying this approach is the general public policy of discouraging fraud.<sup>144</sup> In that regard one federal judge has noted that “there is as much public interest in discouraging fraud as in encouraging letters of credit.”<sup>145</sup> This argument is reinforced by the dictum in the *Sztejn* case where the court stated that the independence principle “presupposes that the presented documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit.”<sup>146</sup> One commentator expressed it as follows:

The certainty of payment of a letter of credit is crucial for those who, as beneficiaries, supply money, goods or services to applicants . . . Yet what about the applicant? To leave the applicant without a remedy against fraud would equally frustrate the applicant’s expectations of the letter of credit. After all, why should a good faith applicant agree to procure the issuance of a letter of credit and reimburse the issuing bank if the letter of credit becomes an automatic and unstoppable vehicle for the perpetration of fraud?<sup>147</sup>

There is also a policy argument that the fraud exception maintains the utility of letters of credit.<sup>148</sup> This argument seeks to justify protection of both the applicant and the issuer in the transaction based on the assertion that

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<sup>143</sup> See, e.g., Buckley & Gao, *supra* note 4, at 664 (stating that the fraud rule allowed the court to go beyond the presented documents and to enjoin payment when fraud was involved); Gao, *supra* note 41, at 56 (stating that the fraud rule allowed courts to go behind the documents and interfere with payment under the credit).

<sup>144</sup> See, e.g., Dolan, *supra* note 4, at 502 (preventing “fraud is legitimate commercial policy, and courts are justifiably concerning that they not fashion law contributing to fraudulent practices”); Buckley & Gao, *supra* note 4, at 665 (arguing that the fraud rule “fills a gap in the law of letters of credit and a public policy requirement.”).

<sup>145</sup> See *Dynamics Corp. of Am. v. Citizens & S. Nat’l Bank*, 356 F. Supp. 991, 1000 (N.D. Ga. 1973).

<sup>146</sup> 31 N.Y.S.2d 631, 634 (N.Y. Special Term 1941). The court continued by stating that the independence principle should not be “extended to protect the unscrupulous seller.” *Id.* See also *O’Meara Co. v. Nat’l Park Bank of N.Y.*, 239 N.Y. 386, 401 (1925) (Cardozo, J., dissenting) (arguing that if the bank knew that the documents presented were false, the bank should not be forced to make payment).

<sup>147</sup> Boris Kozolchyk, *The Immunization of Fraudulently Procured Letter of Credit Acceptances: All Services Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus do Brazil, S.A. and First Commercial v. Gotham Originals*, 58 BROOK. L. REV. 369, 370 (1992).

<sup>148</sup> See, e.g., Buckley & Gao, *supra* note 4, at 666.

continued use of the letter of credit is dependent upon the faith of the users. If there were no fraud exception to the independence principle, this argument asserts that faith in the system of letters of credit would fail and so would the commercial utility of its use.<sup>149</sup> One commentator noted that a legal regime that did not have a fraud exception:

[E]ntails deterrence of potential customer from entering into letter-of-credit transactions. Customers would fear that having paid for nonconforming or worthless goods (in commercial transactions) or that having paid in circumstances in which within the context of the underlying contract, payment was clearly unjustified, their subsequent claim and enforcement proceedings against the beneficiary parties to the transaction would prove to be futile.<sup>150</sup>

Furthermore, this policy argument also focuses on protection of the issuer. As noted earlier, the issuer and the applicant execute a reimbursement agreement under which terms the applicant is required to reimburse the issuer for its payment to the beneficiary under the letter of credit.<sup>151</sup> In the case of a commercial letter of credit, not only is the issuer concerned with the credit worthiness of the applicant and the value of any possible security posted by the applicant to secure the letter of credit, but the issuer might also be interested in the validity of the bills of lading which will be tendered by the

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<sup>149</sup>See *id.* at 667. See also Symons, *supra* note 82, at 379–80 (stating that the fraud exception “would not destroy the commercial utility letters of credit because it serves no commercial purpose to provide certainty of payment to one who has *intentionally* deceived other parties to a transaction.” (emphasis in original)). But see Henry Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 UCC L.J. 7, 11, 14 (1971) (stating that “I fear that the sacred cow of equity may trample the tender vines of letter-of-credit law. . . . The right to enforce express terms, without reference to equities, has long been recognized in letter-of-credit law, and is essential to the proper functioning of the letter-of-credit device.”).

<sup>150</sup>Mautner, *supra* note 17, at 599. See also Kozolchyk, *supra* note 146, at 370 (arguing that applicants would be reluctant to use letters of credit “if the letter of credit becomes and automatic and unstoppable vehicle for the perpetration of fraud.”).

<sup>151</sup>The contractual obligation to reimburse can create financial hardship for the applicant. In the case of a commercial credit where no merchandise was delivered, unless he can recoup the funds paid by the issuer to the beneficiary in subsequent breach of contract litigation, he is in danger of being out both the amount of the purchase price for the goods and the value of the merchandise. A similar problem faces the applicant of a standby credit. Unless subsequent litigation is successful, he is out the amount of the payment made under the letter of credit.

beneficiary along with the draft.<sup>152</sup> Without a fraud exception, one commentator posited that banks might worry that the merchandise which would act as additional collateral might be worthless, and fearing this might require additional security from the applicant such that the applicant might have fewer assets available to fund other transactions.<sup>153</sup> Of course this fear of the issuer can be partially alleviated by requiring verified inspection certificates as a term and condition of the letter of credit; furthermore, this worry does not exist under standby credits as there is no merchandise that can act as security for the issuer.

In response to these policy arguments in favor of the fraud exception it should first be noted that the applicant is not left without a remedy against fraud if there were no fraud exception. In the situation of a commercial letter of credit involving the sale of goods he could sue the beneficiary for breach of its underlying contractual obligation.<sup>154</sup> Furthermore, to prevent litigation in a distant or even foreign jurisdiction, the prudent and careful purchaser should consider inserting a forum selection clause and a choice of law provision in the underlying sales contract. He should also have the contract require commercial arbitration in a specific designated location to resolve any contractual disputes.<sup>155</sup> Additionally, the purchaser should contractually

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<sup>152</sup>This fact was noted in the *Sztejn* case in the following language:

While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account. In fact, the letter of credit requires a bill of lading made out to the order of the bank and not the buyer. Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself that there are some goods represented by the documents.

*Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631, 635 (N.Y. Special Term 1941).

<sup>153</sup>See Mautner, *supra* note 17, at 603–05 (arguing that such a result would be economically inefficient).

<sup>154</sup>Some commentators assert that this potential recovery from the beneficiary is illusory. See Buckley & Gao, *supra* note 4, at 666 (noting that in most cases the fraudster absconds before the fraud or forgery was discovered) (footnote omitted). See also Mautner, *supra* note 17, at 595–97 (arguing that if the applicant's later claims against the beneficiary prove futile, the standing of legal institutions would be prejudiced, there would be a deterrence in the use of letters of credit, and banks would need to obtain additional assurances from an applicant before issuing a letter of credit).

<sup>155</sup>See, e.g., S.I. Strong, *Beyond International Commercial Arbitration? The Promise of International Commercial Mediation*, 45 WASH. U. J. & POL'Y 11, 11 (2014) (stating that “[i]nternational commercial arbitration has long been the preferred means of resolving complex business disputes in the cross-border context.” (footnote omitted)). The author notes that some

require not only a certification by an independent bonded entity as to the quality and existence of the merchandise being shipped,<sup>156</sup> but also should require an on-board negotiable bill of lading establishing that the merchandise is on a carrier.<sup>157</sup>

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people prefer international commercial arbitration due to the easy in enforcing such awards. *Id.* at 27–28 (citing the various treaties and other mechanism for recognition of such awards and their enforcement).

<sup>156</sup> *See, e.g.*, *ACR Sys., Inc. v. Woori Bank*, 232 F. Supp. 3d 471, 474 (S.D.N.Y. 2017) (noting that the letter of credit required in addition to the bills of lading and the commercial invoice an inspection certificate from the person receiving the goods for shipping).

<sup>157</sup> For export of merchandise from the United States, there are two main statutes that govern bills of lading. First, there is the CARRIAGE OF GOODS BY SEA ACT OF 1936, Pub. L. No. 521, ch. 229, 49 Stat. 1207 (1936) (codified as amended at 46 U.S.C. §§ 30701–30707 (2006) (noting in Section 30702 that it applies to the carriage of goods to or from any port in the United States); and there is Article 7 of the U.C.C. *See, e.g.*, *WHITE ET AL.*, *supra* note 23, at ¶ 29:2, p. 392 (citations omitted). *See also* POMERENE ACT, Aug. 29, 1916, ch. 415, 39 Stat. 538 (1916) (codified as amended at 49 U.S.C. §§ 80101–80116 (2006) (noting in Section 80102 that by its terms it does not apply to transportation of goods from a place in a foreign county and to a place in the United States).

For the purpose of this Article, it is important to note that a negotiable bill of lading acts as a receipt of the merchandise by the carrier, is a contract for carriage between the seller (or its agent) and the carrier, but most import in a commercial letter of credit transaction, it is a document of title that controls the possession of the goods. These three characteristics of the bill of lading were succinctly stated by the Second Circuit Court of Appeals as follows:

[A] negotiable or order bill of lading is a fundamental and vital pillar of international trade and commerce, indispensable to the conduct and financing of business involving the sale and transportation of goods between parties located at a distance from one another. It constitutes an acknowledgement by a carrier that it has received the described goods for shipment. It is also a contract of carriage. As a document of title it controls the possession of the goods themselves. It has been said that the bill and the goods become one and the same, with the goods being “locked up in the bill.”

*Berisford Metals, Corp. v. S/S Salvador*, 779 F.2d 841, 845 (2d Cir. 1985). Under a documentary letter of credit transaction, the negotiable bill of lading will be one of the documents that need to be presented to the issuer for payment. The U.C.C. provides that a bill of lading “is negotiable if by its terms the goods are to be delivered to bearer or to the order of a named person.” U.C.C. § 7-104(a). The negotiable bill of lading is issued by the carrier to the order of the beneficiary upon delivery of the merchandise for shipping. The beneficiary will endorse the bill to the issuer who will then be the holder of the bill. The issuer will endorse the bill over to the applicant upon reimbursement. With the bill of lading, the applicant can then receive the merchandise from the carrier by delivering the bill of lading to the carrier in exchange for the goods. *See id.* § 7-502(a)(4).



In addition, in both the commercial credit and the standby credit the applicant can take steps to protect himself from the risks of potential fraud in the first place, by using due diligence in initially selecting and evaluating the reputation and financial status of the other party. In the case of the standby letter of credit, a prudent businessman should never enter into a contractual relationship that authorizes a clean letter of credit where the beneficiary merely presents a draft to the issuer and no other documentation.<sup>158</sup> Such circumstances invite fraud. The underlying contract and the standby letter of credit should each specifically require the presentment of at least a certified letter stating each act of omission or commission by the applicant that constitutes a breach of the underlying contract with specific reference to the underlying contract's provisions. The underlying contract should require notice of any alleged breach with enough time to cure prior to drawing on the letter of credit. In many situations, especially in those cases involving contracts with foreign entities requiring a clean standby letter of credit securitizing a performance bond that is payable upon receiving a letter that the applicant is in breach of the underlying contract, the applicant may not have the bargaining power to negotiate favorable terms. However, in these situations, it should be the applicant who was willing to enter into an arrangement fraught with problems, likely for substantial financial reward, that should shoulder the entire economic losses or litigation time or expense, not the issuer.

The various arguments in favor of the fraud exception fail to fully address the impact that it has on the independence principle. The true concern from a policy standpoint must be centered on preventing a fraudulent party from benefiting from his illicit activity. However, the fraud exception is merely one avenue to achieve this fundamental policy goal. A better solution would be to focus on how to achieve this policy while freeing the independence principle from its tether. This approach involves a totally new paradigm, one that does not focus on the fraudster but focuses upon the two different inquiries. First, who in a letter of credit transaction should bear the risk of fraud and its resultant potential economic loss?<sup>159</sup> Secondly, who in the letter

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<sup>158</sup> See *id.* § 5-109, cmt. 3 (defining a clean letter of credit as “one calling only for a draft and no other documents”). See also MCCULLOUGH, *supra* note 47, at 93 (defining a clean letter of credit as “[a] letter of credit which only requires presentation of a draft or demand for payment, and no other documents.”).

<sup>159</sup> Both before and after the Revised Article 5 one of the leading scholars of the U.C.C. asserted that the extension of the fraud exception beyond the credit transaction itself would destroy the credit

of credit transaction is in the best position to reduce the incidence of fraud? The answer to both questions is the applicant. While the author agrees that society should not condone fraudulent activity, the proper way to achieve this in letters of credit law is to force the applicant to adequately protect itself from the potentially fraudulent activities of the beneficiary. By placing the risk of fraud totally on the applicant, the tether to the independence principle will be abolished and the issuer and the honest beneficiary will be freed from wasteful and time-consuming litigation when an applicant attempts to delay or even prevent the beneficiary from payment under the credit.<sup>160</sup>

The fraud exception had a ring of appeal at a time when international sales transactions or other contractual undertakings were undertaken in a virtual vacuum.<sup>161</sup> When a merchant in New York was selling goods to a merchant in Berlin fifty years ago (or even 20 years ago) or at the same time a contractor was contracting to do construction in a foreign country there were few, if any, avenues for either party to develop sufficient information concerning the credit worthiness or the reputation for honesty and good faith of the other party. However, in today's world there are adequate means to determine these matters. We live in a truly digital world with a free flow of vital commercial information. Furthermore, in the area of commercial letters there are numerous, respected international inspection agencies to verify that the contract merchandise is being shipped and is not rubbish.<sup>162</sup>

#### VII. RECEPTION BY THE COURTS OF THE REVISED FRAUD PROVISION IN ARTICLE 5 OF THE U.C.C.

As noted earlier, although the Revised Article 5-109 and the comments to that section provide examples of the application of fraud in the documents

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devise and makes it the equivalent of a performance bond. *See Dolan, supra* note 19, at 13. Twenty years later Professor Dolan acknowledged that his efforts to limit the fraud exception to only the letter of credit transaction had been largely unsuccessful. *See Dolan, supra* note 4, at 488 (stating that the efforts to limit the fraud exception “have been largely unsuccessful”).

<sup>160</sup>*See Mautner, supra* note 17, at 599 (noting that the fraud exception creates fear in beneficiaries knowing that an applicant can seek to delay or prevent honoring of a presentation).

<sup>161</sup>*Dolan, supra* note 19, at 11 (1985) (noting that allegation of fraud in the underlying transaction or in the credit transaction give courts pause).

<sup>162</sup>*See, e.g., Archer Daniels Midland Co. v. JP Morgan Chase Bank, N.A.*, No. 11 Civ. 0988 (JSR), 2011 WL 855936, at \*2 (S.D.N.Y. Mar. 8, 2011) (noting that the letter of credit required a lab report certifying the quality of the merchandise made by SGS “an international quality inspection company”).

and cite cases which the drafters believed would give enough guidelines as to the standard of material fraud necessary to qualify for injunctive relief, the mere existence of the fraud exception gives hope (perhaps even false hope) to applicants who desire to prevent issuers from honoring a presentation.<sup>163</sup> Thus, the courts are often called to intervene in mere underlying contractual disputes,<sup>164</sup> or in cases where an applicant attempts to extricate itself from a bad economic or business decision.<sup>165</sup> This continued litigation involving the issuer is not justified in a true economic time and cost sense, and there is need to abolish the fraud exception to letters of credit. The abolition of this exception would send a clear message to contracting parties that they should more carefully evaluate their risks before entering into an underlying contract requiring a letter of credit. The fraud exception is wreaking havoc on the independence of commercial obligations by placing financial institutions in the middle of disputes between applicants and beneficiaries. While, arguably, the fraud exception seeks to do what is thought to be fair, the result is to change an independent obligation of “pay now, argue later” into a totally dependent conditional obligation of “argue now, pay later.”<sup>166</sup>

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<sup>163</sup> See *supra* Section V.

<sup>164</sup> See, e.g., *Langley v. Prudential Mortg. Capital Co.*, 546 F.3d 365, 368–69 (6th Cir. 2008) (dissolving a trial court’s granting of a temporary injunction for incorrectly invalidating a forum selection clause), *reh’g denied*, 554 F.3d 647, 649–50 (Moore, J., concurring) (noting that the temporary injunction was invalidated also for finding probably fraud in the transaction when this was really merely a contractual dispute); *Hook Point, LLC v. Branch Banking & Tr. Co.*, 725 S.E.2d 681, 685–86 (2012) (stating that the an argument that the commitment letter limited the utilization of the LC was a mere contract dispute); *Lennar Homes, LLC v. V Ventures, LLC*, 988 So. 2d 660, 662–63 (Fla. Dist. Ct. App. 2008) (affirming a denial of an injunction to enjoin payment on a letter of credit for failing to demonstrate fraud in the draw request for this was merely a question of breach an option agreement dispute).

<sup>165</sup> See, e.g., *3M Co. v. HSBC Bank USA, N.A.*, No. 16 Civ. 5984 (PGG), 2018 WL 1989563, at \*1 (S.D.N.Y. Apr. 25, 2018) (seeking an injunction to prevent payment of a clean letter of credit in a construction job in Turkey); *2002 Irrevocable Trust for Richard C. Hvizdak v. Shenzhen Dev. Bank, Co., Ltd*, No. 2:08-cv-556-FtM-36DNF, 2011 WL 4112776, at \*2 (M.D. Fla. Sept. 15, 2011), *aff’d* *2002 Irrevocable Trust for Richard Hvizdak v. Huntington Nat’l Bank*, 515 Fed. App’x 792 (11th Cir. 2013) (seeking injunctive relief to prevent payment when a sales contract for a boat purchase was breached).

<sup>166</sup> See *Eakin v. Cont’l Ill. Nat’l Bank & Tr. Co. of Chi.*, 875 F.2d 114, 116 (7th Cir. 1989) (stating that “[l]etters of credit are designed to avoid complex disputes about how much the beneficiaries ‘really’ owe”). See also *Dolan*, *supra* note 4, at 502 (noting that the courts need to resist efforts to reorder the transaction “ex post from a pay-now-argue-later regime to a argue-now-pay-later regime” and also stating the applicant should seek his remedy against the beneficiary

This Section of this Article analyzes four cases that exemplify how the fraud exception seriously impairs the independence principle as an efficient commercial device. While the U.C.C. provides high requirements that must be satisfied in order to obtain injunctive relief,<sup>167</sup> these cases establish that a better solution would be for the applicants to be more diligent in the underlying transaction and to let the issuers play the role that they bargained for—honoring presentations that strictly comply with the terms and conditions of the letter of credit. There is absolutely no reason for issuers to be involved in litigation that is totally inefficient and time consuming.<sup>168</sup> In analyzing these cases, it will be necessary to investigate the underlying facts in somewhat tedious detail in order to effectively evaluate how and why the transaction ended up in the courts in the first place and to highlight what the

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where he must pay the costs and assume the risks he undertook when it asked the bank to issue the independent obligation).

<sup>167</sup> See U.C.C. § 5-109(b), cmt. 4 (stating that the standard for injunctive relief is high).

<sup>168</sup> One of the more significant early cases involving the Revised U.C.C. fraud exception spent nearly three years in the courts before a permanent injunction entered by the trial court, reversed by the appellate court, was finally reinstated by the Ohio Supreme Court. See *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, 1999 WL 34828690 (Ohio Com. Pl. Oct. 08, 1999), *rev'd in part and vacated in part*, 2000 WL 1725415 (Ohio App. Nov. 20, 2000), *rev'd*, 768 N.E.2d 619 (Ohio 2002) (noting that the beneficiary induced applicant to obtain a letter of credit for the purchase of winter tires that could not be imported legally by materially false representations with respect to both importability and the availability of more lucrative summer tires). This is a classic case of businessmen so intrigued with the prospect of obtaining Michelin tires at a steep discount for resale at a normal retail price. Instead of trying to protect themselves when they enter into a contract with an unknown seller, they run to the court for assistance when the “too good to be true deal” sours and they are left holding the bag. This is a prime reason that the fraud exception, at least in the case of commercial letters of credit, should be abolished. It encourages lack of due diligence on buyers knowing that they might be able to escape a transaction after the fact.

The risks of a sale can be allocated between the parties to the underlying sales transaction by have it in writing, checking the references of the parties involved (perhaps having references given), checking the financial status of the seller to insure no chance of insolvency, having an independent inspection of the goods to ensure quality, and requiring a clean bill of lading. All of these things are possible today given the digital age and the ease of obtaining financial information through corresponding banks and the internet. See Rocco D'Ascenzo, *The Supreme Court of Ohio's Decision in Mid-American Tire, Inc. v. PTZ Trading Ltd., and the Weakening of the Independence Principle*, 32 CAP. U. L. REV. 1097, 1121–25 (2004) (listing things that the purchaser's attorney could have done to protect his client without seeking court intervention).

applicants should have done to prevent the problem in the first place and to save the issuers and the courts time and money.<sup>169</sup>

*Archer Daniels Midland Co. v. JP Morgan Chase Bank, N.A.* is the first case.<sup>170</sup> The case involved the sale of rice by a subsidiary of Archer Daniels Midland Co (ADM Rice) to the Grain Board of Iraq (GBI), an entity under the supervision of the Iraqi Government's Ministry of Trade.<sup>171</sup> Under the arrangement of the parties, ADM Rice was to post a performance bond through an Iraqi Bank to guaranty the quality of the rice or wheat.<sup>172</sup> ADM Rice applied for a letter of credit with JP Morgan Chase (Chase) which was contingent on an Iraqi bank issuing a performance bond to GBI guarantying ADM Rice's performance of the sales contract.<sup>173</sup> The letter of credit was subsequently issued with ADM as the account holder and TBI (an Iraqi bank), another Iraqi governmental entity, as beneficiary.<sup>174</sup> The letter of credit provided in part that TBI could draw on the letter when it had received a claim in accordance with the terms of the performance bond which was issued by TBI shortly after the issuance of the letter of credit.<sup>175</sup> The letter of credit incorporated the terms of the performance bond which specifically provided that all claims made under the bond must be "accompanied by an SGS original laboratory report specifically certifying that the quality of purchased commodity does not meet the contractual specifications."<sup>176</sup> However, the letter of credit only required that GBI provide TBI with the

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<sup>169</sup>The issuer may be able to recover its reasonable attorney's fees and litigation expenses if it is a prevailing party in an action under Article 5. *See* U.C.C. § 5-111(e), cmt. 6 (noting that while the issuer may be entitled to such fees and expenses pursuant to its reimbursement agreement with the applicant "allowing the issuer to recover those fees from a losing beneficiary may also protect the applicant against undeserved losses."). Notwithstanding the recovery of such fees, the issuer has additional economic losses derived from the fraud litigation, including time and effort spent in preparing and participating in the trial.

<sup>170</sup>No. 11 Civ. 0988 (JSR), 2011 WL 855936 (S.D.N.Y. Mar. 8, 2011).

<sup>171</sup>*Id.* at \*1.

<sup>172</sup>*Id.*

<sup>173</sup>*Id.*

<sup>174</sup>*Id.*

<sup>175</sup>*Id.* at \*2. The letter of credit provided, "[Funds are] . . . available against your authenticated Swift/Tested Telex that you have duly issued your Performance Bond as requested by ourselves and that you have received a claim in accordance with the terms of the performance bond." *Id.*

<sup>176</sup>*Id.* at \*2 (stating that the SGS was "an international quality inspection company").

SGS report, but did not require that a copy of that report be presented to Chase in order to request payment under the letter of credit.<sup>177</sup>

The parties had done numerous other transactions.<sup>178</sup> In some of these other transactions there had been grain quality issues which were resolved informally with ADM Rice agreeing to satisfy all claims without a request under the performance bond.<sup>179</sup> However, this time there was a call on the performance bond and then a subsequent demand for payment under the standby letter of credit.<sup>180</sup> ADM filed suit seeking a temporary restraining order to prevent Chase from honoring the draw by TBI alleging that there was fraud as no adverse quality report had been issued by SGS.<sup>181</sup> Following a hearing on the preliminary injunction, the court determined that there was no “plausible or colorable basis under the contract for TBI’s request for payment under the letter of credit” as there was no adverse quality report issued by SGS and that TBI’s representation to Chase was “almost certainly false.”<sup>182</sup> The court noted that TBI had complied with the terms and conditions under the letter of credit, but that fraud in the transaction constitutes a “well established exception” to the independence principle.<sup>183</sup> Thus, the court granted a preliminary injunction enjoining Chase from honoring the presentation.<sup>184</sup>

This case is a prime example of a lack of diligence by the applicant. While 4.4 million tons of grain had previously been shipped by ADM Rice without any problems, it unwisely failed to adequately protect itself by making the letter of credit specify that one of the documents that needed to be presented to Chase under the terms of the letter of credit was the SGS certificate showing that the grain was not up to contract specifications. The injunction in the face of fraud in the transaction was used against a bad faith party to prevent the issuer from paying money on a fraudulent statement.<sup>185</sup> But why

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<sup>177</sup> *Id.*

<sup>178</sup> *Id.* at \*1.

<sup>179</sup> *Id.* (stating that ADM Rice had sold extensive amounts of grain commodities through GBI since 2005).

<sup>180</sup> *Id.* (stating that the draw was for the sum of \$6,926,850).

<sup>181</sup> *Id.* at \*3.

<sup>182</sup> *Id.* at \*6 (concluding that “the most reasonable interpretation of the relevant circumstances is the TBI’s request was made in an attempt to effectuate a fraud”).

<sup>183</sup> *Id.* at \*5.

<sup>184</sup> *Id.* at \*6.

<sup>185</sup> *Id.*

this litigation with the bank? Why should the independence principle be corroded due to the failure of an applicant to use due diligence in a commercial sales transaction? Why not let the parties protect themselves or suffer the consequences?<sup>186</sup> This was a sale for \$69 million and involved almost a \$7 million clean letter of credit. ADM Rice could have protected itself, but it apparently let down its shield because of the success of other earlier transactions.<sup>187</sup> While successful in obtaining the injunction, all this time and expense could have been avoided by careful drafting and diligently being aware of the changing political realities in Iraq.

*3M Company v. HSBC Bank USA, N.A.* is the second case.<sup>188</sup> The case involved an Electronic Toll Collection System project in Turkey for PTT, a subdivision of the Turkish Government.<sup>189</sup> Vendeka was the prime contractor on the job and 3M was a subcontractor.<sup>190</sup> Under the terms of the subcontract, 3M was to obtain a letter of credit to guarantee Vendeka's performance under its contract with PTT.<sup>191</sup>

The letter of credit that was issued was in favor of a Ziraat Bank (a Turkish bank) and provided that Ziraat Bank would issue a "guarantee" (letter of credit) to Aktif Bank (another Turkish bank), and that Ziraat Bank would request that Aktif Bank issue its local guarantee (letter of credit) in favor of the PTT.<sup>192</sup> The letter of credit obtained by 3M from HSBC recited

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<sup>186</sup> See, e.g., WHITE ET AL., *supra* note 23, at ¶ 26:38, p. 250 (6th ed. 2014) (positing that "Archer must have kicked itself for failing to make the presentation of a negative SGS report as part of the presentation on the letter of credit.").

<sup>187</sup> It is unclear from the case when the other successful transactions had occurred, but the contract for this sale was completed after the last allied combat troops had left Iraqi and entered Kuwait—August 18, 2010. See Jane Arraf, *Iraq War: Last US Combat Brigade Crosses into Kuwait*, THE CHRISTIAN SCIENCE MONITOR (Aug. 19, 2010), <https://www.csmonitor.com/World/Middle-East/2010/0819/Iraq-war-Last-US-combat-brigade-crosses-into-Kuwait> As conditions were changing in Iraqi, perhaps more diligence should have been undertaken by a large conglomerate with world-wide connections.

<sup>188</sup> No. 16 Civ. 5984 (PGG), 2018 WL 1989563 (S.D.N.Y. Apr. 25, 2018).

<sup>189</sup> *Id.* at \*1.

<sup>190</sup> *Id.* at \*1–2. 3M acquired the rights and duties of the original subcontract as a result of an asset purchase agreement whereby the original subcontractor assigned the subcontract ("Service Agreement") to 3M; the assignment was subsequently agreed to by Vendeka. *Id.* at \*2.

<sup>191</sup> *Id.* at \*2.

<sup>192</sup> *Id.* at \*4 (noting that this was a three-bank structure whereby HSBC would issue its standby letter of credit in favor of Ziraat Bank which would issue its letter of credit to Aktif Bank which would issue a local guarantee to PTT).

that its purpose was to guarantee the general contractor's "delivery of the toll road equipment and systems specified" in a provision of the agreement between the 3M and the general contractor.<sup>193</sup> The original letter of credit provided that Ziraat Bank could only draw on the letter of credit if a demand for payment was made according to the terms of its letter of credit issued to Aktif Bank and that such demand was due to 3M's responsibilities under its contract with the general contractor.<sup>194</sup> However, the letter of credit was amended at the request of Ziraat Bank, as a requirement by Aktif Bank before it would issue its local guarantee to PTT.<sup>195</sup> 3M approved the amendment that deleted any reference to the condition set forth in the original letter of credit stating that the demand was a result of the 3M's failing to perform under its contract.<sup>196</sup>

The Amended HSBC Letter of Credit provided that payment to Ziraat Bank would be due once HSBC received Ziraat Bank's "written demand via authenticated SWIFT," such demand being supported by a "written statement [from Ziraat Bank] certifying that [Ziraat Bank] ha[s] received a demand for payment under [the letter of credit Ziraat Bank issued in favor of Aktif Bank] in accordance with [that letter of credit's] terms."<sup>197</sup>

A demand was subsequently made on the letter of credit issued by HSBC with documents that facially conformed to the letter of credit's drawing requirements.<sup>198</sup> 3M sought an injunction claiming fraud in the transaction.<sup>199</sup> But the court noted that the letter of credit was clean, requiring only a demand and written statement from the Ziraat Bank that it had received a demand for

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<sup>193</sup> *Id.*

<sup>194</sup> Ziraat Bank could draw on the letter of credit if it made a demand for payment "supported by [a] written statement certifying that [it had] received a demand for payment . . . in accordance with [the] terms [of the letter of credit it had issued to Aktif Bank] and that such demand is due to Federal Signals Technologies['] responsibility under Section 4.2 of the Service Agreement." *Id.* 3M had purchased all the assets of Federal Signals Technologies and was the assignee of the Service Agreement. *Id.* at \*2.

<sup>195</sup> *Id.* at \*4.

<sup>196</sup> *Id.* at \*4–5.

<sup>197</sup> *Id.* at \*4.

<sup>198</sup> *Id.* at \*10.

<sup>199</sup> *Id.* at \*6 (claiming that not only was PTT demand for payment on Aktif Bank's letter of credit fraudulent, but also alleging that Ziraat Bank was a direct participant in the fraudulent transaction as it had refused to provide HSBC documents that it had requested including documentation of its letter of credit in favor of Aktif Bank and of the demand made by that bank on Ziraat Bank).



payment under the amended letter of credit in accordance with the letter of credit's terms.<sup>200</sup> 3M alleged that the refusal of Ziraat Bank to provide documentation concerning Aktif Bank's demand on Ziraat Bank and of the letter of credit in favor of Aktif Bank was circumstantial evidence of fraud.<sup>201</sup> However, the court noted that the amended letter of credit in favor of Ziraat Bank did not require this documentation.<sup>202</sup> The trial court found 3M had failed to demonstrate a likelihood of success on its claims of fraud by Ziraat Bank and denied the application for a preliminary injunction.<sup>203</sup>

3M was a multinational corporation with extensive business acumen. Why would it agree to a clean letter of credit which only required a letter stating that Ziraat Bank had received a demand for it to pay on its guarantee? Why would it agree to the amending of the letter of credit deleting that the demand on the credit had to be based on 3M's breach of the contract with the contractor? When that request was made, red flags should have gone up. However, apparently this was a lucrative contract which 3M wanted as reflected by the assignment of that contract in the asset purchase agreement with the original subcontractor. In allowing the amendment of the letter of credit it had applied for, 3M opened the door for the problems it got itself into—another too good deal that went sour. Even the court noted that 3M created its own problem in the following language:

3M's agreement to Ziraat Bank's proposed amendment to the HSBC Letter of Credit—which removed the reference to Section 4.2 of the Service Agreement—left it vulnerable, because the letter of credit it was providing was no longer

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<sup>200</sup> *Id.* at \*10. The court noted that the Official Comment 3 to U.C.C. § 5-109 says that courts should be skeptical of claims of fraud involving clean letters of credit. *Id.* (noting that the letter of credit in this case was a clean one).

<sup>201</sup> *Id.* at \*11.

<sup>202</sup> *Id.* In a footnote that accompanied this statement by the court, the court noted that the demand by the Ziraat Bank was in conformity with the terms of the letter of credit and that 3M "has not shown that HSBC has a legal duty to conduct any further investigation." *Id.* at \*11 n.12. This statement by the court upholds the true independence of the letter of credit. *See also* Hook Point, LLC v. Branch Banking & Tr. Co., 725 S.E.2d 681, 685 (S.C. 2012) (refusing to consider a loan commitment agreement that stated when a letter of credit could be drawn because the plain language of the letter of credit authorized a draw upon presentation of only a draft, the original letter of credit, and a notarized statement that borrower was in default of the loan agreement).

<sup>203</sup> *3M Co.*, 2018 WL 1989563, at \*13. The court also rejected 3M's assertion that alleged fraud committed by PTT could be imputed to Ziraat Bank. *Id.* at \*11–12 (noting that 3M's own evidence presented a non-fraudulent explanation for PTT's draw on Aktif Bank).

tethered to its own performance. Under the Service Agreement with Vendeka, 3M was only obligated to post a letter of credit in favor of Vendeka to guarantee 3M's performance as subcontractor. But by consenting to the amendment of the HSBC Letter of Credit, 3M permitted the reference to these drawing conditions—tied to 3M's own performance in connection with the HGS Project—to be eliminated. 3M thereby left itself unprotected with respect to a drawdown by PTT on the Aktif Bank letter of credit, which in turn provoked Ziraat Bank's drawdown on the Amended HSBC Letter of Credit.<sup>204</sup>

Due diligence could have prevented this dilemma, but alas, dragging HSBC into the court to get relief that it could have prevented is not productive or economically efficient. The use of the fraud exception to the independence principle was misused. The applicant chose to permit the amendment to the letter of credit.<sup>205</sup> That was clearly a business mistake. Since the applicant made the mistake, it should pay the cost of its decision and not commerce in general. Anyone who contractually agrees to a clean letter of credit should not involve issuers in subsequent litigation.

Two other recent cases show a complete lack of diligence and investigation by purchasers who, when the underlying contract was breached, alleged fraud seeking to prevent the honoring of letters of credit. Both cases involve individuals interested in purchasing expensive luxury yachts from a Chinese boat manufacturer. In *2002 Irrevocable Trust for Richard C. Hvizdak v. Shenzhen Dev. Bank Co.*, the 2002 Irrevocable Trust for Hvizdak ("Trust") entered into a written contract for the purchase of two custom 127-foot yachts with Foshan Poly Marine Engineering, Co. ("Foshan") on August 19, 2004.<sup>207</sup> Under the terms of the contract, the Trust was to provide a financial commitment for the construction of the two yachts by having two \$2.5 million standby letters of credit issued by a Florida bank ("Bank") with Shenzhen Development Bank ("Shenzhen") as beneficiary.<sup>208</sup> Shenzhen was

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<sup>204</sup> *Id.* at \*12.

<sup>205</sup> *Id.* at \*5.

<sup>207</sup> No. 2:08-CV-556-FtM-36DNF, 2010 WL 11512368, at \*1 (M.D. Fla. Mar. 26, 2010), *aff'd sub nom.* 2002 Irrevocable Tr. for Richard C. Hvizdak v. Huntington Nat'l Bank, 428 F. App'x 924 (11th Cir. 2011).

<sup>208</sup> *Id.*

the beneficiary under the credits to secure its \$5 million loan to Foshan.<sup>209</sup> The sales contract also obligated Foshan to post two \$6.5 million performance bonds.<sup>210</sup> Those bonds were never posted,<sup>211</sup> and in January 5, 2005 the Trust cancelled the contracts for the boat construction and the next day sought cancellation of the letters of credit, but the Shenzhen refused to do so.<sup>212</sup>

Over three years later, on the expiry date of the letter of credit, Shenzhen made a draw request stating that the amount of the draw represented the outstanding indebtedness owed Shenzhen by Foshan.<sup>213</sup> Litigation followed.<sup>214</sup> The Trust originally sought an injunction to prevent the issuer from honoring the draw,<sup>215</sup> and it subsequently amended its suit to allege four claims against Shenzhen and others.<sup>216</sup> The Trust's amended pleadings did not plead for injunctive relief<sup>217</sup> but asserted "letter of credit fraud" under U.C.C. § 5-109.<sup>218</sup>

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<sup>209</sup> *Id.* at \*5 (stating that loan amount was the amount requested by Foshan to construct the two yachts with the source of repayment stated as "income upon delivery of boat or standby letter of credit guarantee").

<sup>210</sup> *Id.* at \*1.

<sup>211</sup> *Id.* (noting that the Trust was never given assurances that the bonds would be posted from Peter Tsou, President of Custom Marine International, who had been the individual who had initially informed the Trust of Foshan).

<sup>212</sup> *Id.*

<sup>213</sup> *Id.* The applicant had filed a complaint against the Bank, Shenzhen, and Foshan six days earlier apparently either because the Trust was advised of the coming draw request or as a precautionary matter.

<sup>214</sup> *Id.*

<sup>215</sup> *Id.* The documents that were presented were in strict compliance with the terms of the letter of credit. *Id.* at \*5.

<sup>216</sup> *Id.* at \*1.

<sup>217</sup> Prior to filing its amended pleadings, the parties settled the issue relating to injunctive relief. *See* 2002 Irrevocable Tr. for Richard C. Hvizdak v. Shenzhen Dev. Bank, Co., No. 2:08-cv-556-FtM-36DNF, 2011 WL 4112776, at \*1 (M.D. Fla. Sept. 15, 2011), *aff'd sub nom.* 2002 Irrevocable Tr. for Richard C. Hvizdak v. Huntington Nat'l Bank, 515 F. App'x 792 (11th Cir. 2013).

<sup>218</sup> In a subsequent suit by Shenzhen to recover attorney's fees and expenses under U.C.C. § 5-111(e), the appellate court held that notwithstanding the fact that the Trust's amended complaint did not seek injunctive relief, its theory of liability was under Section 5-109 and therefore, the trial court did not abuse its discretion in granting Shenzhen attorney's fee and expenses under the U.C.C. *See* 2002 Irrevocable Tr. for Richard C. Hvizdak v. Huntington Nat'l Bank, 515 F. App'x 792, 794 (11th Cir. 2013) (noting that although the Trust did not seek an injunction, its entire theory of liability was letter of credit fraud as defined in Section 5-109). U.C.C. § 5-111(e) states:

The case highlights several instances of a lack of diligence or inquiry on the part of the Trust. The court concluded that while a letter of credit transaction is supposedly between sophisticated parties who can and should look after their own interests,<sup>219</sup> the Trust failed to act as a sophisticated party making a multimillion-dollar purchase. In this regard the court stated:

At oral argument, Plaintiffs also contended that, if Shenzhen had not omitted that it was planning to make a loan and not tie it directly to the two yachts and if it had not omitted that the loan would be dispersed before the performance bonds were issued, then Plaintiffs would not have carried out this transaction. But, Plaintiffs effectuated the letter of credit before the Foshan Poly Marine performance bonds were issued. This was a volitional act that Plaintiffs took without regard to the potential consequences. “. . . [E]very person must use reasonable diligence for his own protection . . . where the means of knowledge are at hand and are equally available to both parties, and the subject matter is equally open to their inspection, if one of them does not avail himself of those means and opportunities, he will not be heard to say that he was deceived by the other’s misrepresentations.”<sup>220</sup>

In this regard, the Trust claimed that Shenzhen was negligent in that it owed a duty to the Trust to exercise reasonable care to see that the loans it made to Foshan were earmarked for the building of the Trust’s yachts as those loans were secured by the letters of credit.<sup>221</sup> The court noted that if the Trust wanted Shenzhen to monitor the use of the loaned funds, the Trust could have placed that requirement as one of the terms of the letter of credit.<sup>222</sup>

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“[r]easonable attorney’s fees and other expenses of litigation must be awarded to the prevailing party in an action which a remedy is sought under the article.” U.C.C. § 5-111(e).

<sup>219</sup> *Hvizdak*, 2010 WL 11512368, at \*2. (citing Buckley & Gao, *supra* note 4 at 308).

<sup>220</sup> *Id.* at \*6 (noting as there was no duty to disclose as there was no fiduciary duty between Shenzhen and the Trust, thus the claim for negligent misrepresentation failed) (citing Potakar v. Hurtak, 82 So.2d 502, 504 (Fla. 1955) which held a contract could not be rescinded because there were not specific allegations demonstrating reasonable reliance).

<sup>221</sup> *Id.*

<sup>222</sup> The loan agreement between Shenzhen and Foshan explicitly stated that the loan proceeds were to be used for the building of the two yachts, but such language was absent from the letters of credit. *Id.* at \*6.

To show the extent of desperation of the Trust's arguments seeking to recover from Shenzhen for fraud and failure to disclose material facts, the Trust alleged that Shenzhen had knowledge of Foshan's prior fraudulent activities and failed to advise the Trust of these activities.<sup>223</sup> In this regard, the Trust cited a 2004 case involving Foshan filed in federal court in Florida.<sup>224</sup> In rejecting this argument the court noted:

There is no evidence in the record to suggest how Shenzhen, a Chinese bank, could be expected to know or follow lawsuits taking place . . . thousands of miles away from it, when Shenzhen was not a party to the suit. The record evidence established that Shenzhen approved the loan to Foshan Poly Marine before service was obtained on any of the defendants in the *Seascope Yacht* case, and thus could not have disclosed information about the suit to Plaintiffs.<sup>225</sup>

Of course, the Trust should have sought legal advice. That advice would have most likely included a recommendation of using a commercial letter of credit authorizing payment upon delivery of the constructed boat, rather than a standby letter of credit securitizing Shenzhen's loans to Foshan. Once again, the facts of this case show a lack of diligence that leads to an applicant running to the court in an attempt to escape from its original transaction. While the standard for the application of the fraud rule is set high, abuse by applicants has not dissipated. As deals in the commercial world can fall apart in a variety of ways and for a variety of reasons, applicants will be tempted to use every means at their disposal to avoid the adverse consequences of a sour deal. As long as there is a fraud exception, one of those means will be running to the court to seek an injunction to delay or prevent the honoring of the presentation. The effect of the fraud exception is to distract from the commercial purpose of the letter of credit as a valid instrument in international business insuring prompt payment upon the proper presentation of documents.<sup>226</sup>

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<sup>223</sup> *Id.* at \*3.

<sup>224</sup> *Id.*

<sup>225</sup> *Id.* at \*4 (noting also that the case involved a predecessor entity distinct from Foshan Poly Marine the entity involved in this case).

<sup>226</sup> To add insult upon insult (or perhaps to pour salt into the wound), Shenzhen obtained a judgment for attorney's fees and expenses in the amount of \$434,036.90 under the Florida

The fourth and final case is another case involving Foshan Polymarine Engineering Co. (“Foshan”). This case involved a contract for the purchase of a \$6,030,500.00 luxury motor yacht to be built in China.<sup>227</sup> The purchaser in this case (Jaffe) admitted that it wanted to buy the boat cheap from a Chinese company and then “flip” it for a \$3 million dollar profit.<sup>228</sup> The sales contract between Jaffe and Foshan required a standby letter of credit, and one was initially issued by Bank of America (“BOA”) for a small portion of the sales price with Foshan as the beneficiary; however, the credit was subsequently amended for the total amount of the sales price naming Agricultural Bank of China (“ABC”) as the beneficiary.<sup>229</sup> The sales contract

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equivalent to U.C.C. § 5-111(e). 2002 Irrevocable Tr. for Richard C. Hvizdak v. Huntington Nat’l Bank, 515 F. App’x 792, 793 (11th Cir. 2013). *See also supra* note 218.

<sup>227</sup>*See* Jaffe v. Bank of Am., N.A., 667 F. Supp. 2d 1299, 1304 (S.D. Fla. 2009), *aff’d* 395 F. App’x 583 (11th Cir. 2010). The case started with the purchasers [Jaffe] seeking a temporary restraining order and injunctive relief against Bank of America, N.A., [BOA] to enjoin it from paying a letter of credit to either Foshan or the Agricultural Bank of China [ABC] claiming that the presentment was fraudulent, and honor of the credit would facilitate a material fraud by the Foshan upon Jaffe. *Id.* at 1304. Although not parties to the suit at the time of the hearing on the temporary injunction, the court had previously ordered both ABC and Foshan to appear at the hearing as the allegation in the complaint stated that these co-conspirators sought to fraudulently acquire funds intended by Jaffe for the construction of the yacht. *Id.* at 1305 (noting that the two ignored the court’s order).

On May 4, 2007, the trial court entered its temporary injunction enjoining BOA from disbursing funds under the letter of credit. *Id.* at 1306. The court entered the temporary injunction because of the “uncontradicted proof of Plaintiff’s [Jaffe] serious allegations of fraud.” *See* Jaffe v. Bank of Am., N.A., No. 07-21093-CIV, 2008 WL 623031, at \*1 (S.D. Fla. Mar. 6, 2008). On June 1, 2007, ABC filed a motion to intervene and to vacate the temporary injunction. *Jaffe*, 667 F. Supp. 2d at 1306. A week later, BOA filed its answer to the original petition, filed a counterclaim against the Jaffe, and filed third party claims against ABC and Foshan seeking a declaration of rights among the parties. *Id.* Jaffe then filed an amended complaint against BOA, ABC, and Foshan leveling major complaints against BOA. *Id.* at 1307 (alleging that the bank had made misstatements and omissions that amount to negligent misrepresentation, breach of fiduciary duty, and equitable estoppel). All the claims against Foshan were dismissed for failure to obtain service. *Id.*

Following the trial court’s refusal to vacate the preliminary injunction, ABC appealed, and the court of appeals affirmed holding that the district court had not abused its discretion in continuing the preliminary injunction. *Jaffe v. Bank of Am., N.A.*, 276 F. App’x 932, 933 (11th Cir. 2008). The case was finally tried in 2009. *Jaffe*, 667 F. Supp. 2d at 1307 (noting the trial was during the period June 29, 2009 through July 2, 2009). The trial court denied the permanent injunction and vacated the preliminary injunction. *Id.* at 1323.

<sup>228</sup>*Id.* at 1309.

<sup>229</sup>*See* Jaffe v. Bank of Am., N.A., No. 07-21093-CIV, 2008 WL 11333769, at \*2 (S.D. Fla. Oct. 10, 2008). The letter of credit naming ABC as beneficiary was to provide additional security

also required Foshan to post a performance bond to guarantee construction of the yacht and required Jaffe to increase the amount of the letter of credit once the performance bond was issued.<sup>230</sup> Although the boat was never constructed, a demand for a draw on the letter of credit was made and litigation ensued.<sup>231</sup>

The court's finding of facts following the trial<sup>232</sup> established that Jaffe was a successful and sophisticated businessman who owned several automobile dealerships and had done more than \$1 billion in loans during his career.<sup>233</sup> Jaffe refused to seek expert advice on undertaking this transaction involving a standby letter of credit.<sup>234</sup> Although he testified that he wanted a "no boat, no money" stipulation in the letter of credit,<sup>235</sup> the letter of credit that he approved and signed did not contain that language.<sup>236</sup> Furthermore, under the sales contract, Jaffe had the right to have his own representative present at all times during the construction of the yacht and to supervise the building process, but he never exercised that right.<sup>237</sup> As can be expected, the

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for ABC to make a loan to finance the construction of the yacht by Foshan. *See* Jaffe v. Bank of Am., N.A., 395 F. App'x 583, 585 (11th Cir. 2010).

<sup>230</sup> *See* Jaffe v. Bank of Am., N.A., No. 07-21093-CIV, 2008 WL 11333769, at \*2 (S.D. Fla. Oct. 10, 2008) (noting that shortly after the performance bond was issued in the amount of \$6,100,000 that the letter of credit was increased from \$350,000 to \$6,030,500). The performance bond was acquired from a company in August of 2004, and in October of 2004, Jaffe was notified by the FBI that the bond was fraudulent. Jaffe v. Bank of Am., N.A., 667 F. Supp. 2d 1299, 1317, *aff'd* 395 F. App'x 583 (11th Cir. 2010) (noting that although he had obtained and paid for the bond which would have guaranteed payment to him in the event the yacht was not build, he did not advise BOA that it was phony and worthless).

<sup>231</sup> In October of 2004, Jaffe learned that the yacht was not being built and contacted BOA in an attempt to cancel the credit but was told that "if ABC requested a draw on the letter of credit, it would be paid." *Id.* Nearly three years later a draw was made on the letter of credit but was unsuccessful as a preliminary injunction had been issued days before. *See* Jaffe v. Bank of Am., N.A., No. 07-21093-CIV, 2008 WL 11333769, at \*2 (S.D. Fla. Oct. 10, 2008).

<sup>232</sup> *See supra* note 216 (citing to the various causes of action that were involved in the trial).

<sup>233</sup> Jaffe v. Bank of Am. N.A., 667 F. Supp. 2d 1299, 1315 (S.D. Fla. 2009), *aff'd* 395 F. App'x 583 (11th Cir. 2010).

<sup>234</sup> *Id.* at 1316 (finding that Jaffe was advised by his lawyer after reviewing the letter of credit that he had concerns about it and recommended to Jaffe to get an expert on banking instruments).

<sup>235</sup> *Id.* at 1316–17 (stating that the court doubted that Jaffe had ever told the bank officials that he wanted a "no boat, no money" stipulation in the letter of credit and found that Jaffe did not tell the bank officials to include the stipulation).

<sup>236</sup> *Id.* at 1317.

<sup>237</sup> *Id.* at 1322.

yacht was never built nor delivered, and ABC subsequently attempted to make a draw on the standby letter of credit which was issued as collateral for the loan that ABC had made to Foshan to build the yacht.<sup>238</sup>

As the litigation rolled along, the temporary injunction was vacated<sup>239</sup>; the motion to stay/restore the injunction pending an appeal was denied<sup>240</sup>; ABC got its payment under the letter of credit<sup>241</sup>; BOA was awarded attorneys' fees, costs, and expenses in the amount of \$469,134.03<sup>242</sup>; and ABC was awarded the \$150,000 injunction bond that had been posted by Jaffe in the action.<sup>243</sup> Once again, we see what happens when a person enters into a transaction that he is not fully competent to undertake and refuses to get advice that would keep him out of the soup he ends up in after following his own advice. In this case, the following events are telling about Jaffe's inability to conduct this transaction on his own and lack of due diligence:

1. Jaffe approved the letter of credit language which did not include the stipulation that the money would only be paid on completion of the yacht. Of course, this could have easily been a condition in a standard commercial letter of credit.<sup>244</sup>
2. Jaffe relied upon his own business acumen and refused to seek expert advice on letters of credit, although he had been

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<sup>238</sup>The amended letter of credit stated that BOA would pay ABC up to \$6,030,500 upon presentation of a certified statement stating that "[t]he amount of the draft drawn hereunder represented and covers the unpaid balance of indebtedness including interest and bank charges, if any, due to the beneficiary by FoShan Poly Marine Engineering Co. L.T.D." See *Jaffe v. Bank of Am., N.A.*, 395 F. App'x 583, 585 (11th Cir. 2010).

<sup>239</sup>*Jaffe v. Bank of Am., N.A.*, 667 F. Supp. 2d 1299, 1323 (S.D. Fla. 2009), *aff'd* 395 F. App'x 583 (11th Cir. 2010.)

<sup>240</sup>*Id.* at 1324.

<sup>241</sup>*Id.* at 1323–24 (holding that the preliminary injunction enjoining BOA from paying on the letter of credit for over almost the last two years was vacated and the court denied the Jaffe's motion to stay its order pending an appeal).

<sup>242</sup>*Jaffe v. Bank of Am., N.A.*, 674 F. Supp. 2d 1360, 1365–66 (S.D. Fla. 2009), *aff'd* 399 F. App'x 535 (11th Cir. 2010). The trial court awarded recovery for BOA under U.C.C. § 5-111(e) and under the terms of the application for the letter of credit executed by Jaffe. *Id.* at 1363–65.

<sup>243</sup>The bond posted by Jaffe on the issuance of the preliminary injunction was for "the payment of such costs and damages as may be incurred or suffered by any party who was found wrongfully enjoined. *Id.* at 1366 (noting that while BOA was the party enjoined it was only ABC that opposed the injunction and had requested the posting of the bond).

<sup>244</sup>*Jaffe v. Bank of Am., N.A.*, 667 F. Supp. 2d 1299, 1310–11 (S.D. Fla. 2009), *aff'd* 395 F. App'x 583 (11th Cir. 2010).



advised to seek such advice by an attorney that he retained for a very limited purpose.<sup>245</sup>

3. Jaffe read, approved, and signed the letter of credit even though it did not include his alleged requirement of “no boat, no money.”<sup>246</sup>

4. Jaffe was apparently not concerned about the overall financial arrangements as he expect to sell his contract to purchase the boat and make a 50% profit.<sup>247</sup>

5. Jaffe was on the line for over \$6 million and only protected himself by having Foshan have ABC issue a \$300,000 letter of credit as liquidated damages if the boat was not built.<sup>248</sup>

Once again, we see that lack of due diligence creates a problem for a yacht buyer. While not all risks can be eliminated in a letter of credit transaction, there are ways individuals can protect themselves. In both yacht purchase cases, an individual using due diligence should have perceived that the Chinese banks wanted to shift the risk of non-payment of the loans from themselves to the purchasers of the boats by being named the beneficiaries on the standby letters of credit.<sup>249</sup> The presentation requirement in both cases

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<sup>245</sup> *Id.* at 1316 (noting that after the lawyer he retained to look at the sales contract expressed concern over the BOA letter of credit, Jaffe refused further advise or assistance from the lawyer).

<sup>246</sup> *Id.* at 1316 (noting that he was also aware that the credit was irrevocable).

<sup>247</sup> *Id.*

<sup>248</sup> *Id.* at 1317.

<sup>249</sup> *Id.* at 1304–05 (alleging in the Verified Complaint that Foshan had “provided the letter of credit to its bank Agricultural Bank of China (ABC) as security for debts unrelated to the Jaffe project”). See also *Jaffe v. Bank of Am., N.A.*, 395 F. App’x 583, 585 (11th Cir. 2010) (stating that the contract required the credit to provided collateral security for ABC to make loans to Foshan for the construction of the boats). This should have been clearly apparent to Jaffe when he approved the amendment to the original letter of credit changing the beneficiary from Foshan to ABC. See *Jaffe v. Bank of Am., N.A.*, 667 F. Supp. 2d 1299, 1310 (S.D. Fla. 2009), *aff’d* 395 F. App’x 583 (11th Cir. 2010). See 2002 Irrevocable Tr. for Richard C. Hvizdak v. Shenzhen Dev. Bank, Co., Ltd., No. 2:08-cv-556-FtM-36DNF, 2010 WL 11512368, at \*1 (M.D. Fla. Mar. 26, 2010), *aff’d sub nom.* 2002 Irrevocable Tr. for Richard C. Hvizdak v. Huntington Nat’l Bank, 428 F. App’x 924 (11th Cir. 2011). In order for the Shenzhen to draw on the letters of credit, it had to make working capital loans to Foshan. *Id.* at \*5. Any prudent businessman could have determined that the letters of credit were to collateralize the Shenzhen’s loan to Foshan. *Id.* The loan made by the Bank to Foshan was \$5 million dollars and each letter of credit was for \$2.5 million dollars. *Id.* at \*1.

was merely a letter stating the amount of the unpaid loan balance accompanied with a draft in that amount,<sup>250</sup> without any requirement for documentation of the loan, payments under the loan, or other matters. This should have been a serious concern for a prudent businessman but was apparently unimportant to the purchasers who failed to adequately protect themselves.

VIII. RECOMMENDATION TO UNTETHER THE FRAUD EXCEPTION AND TO LIBERATE THE INDEPENDENCE PRINCIPLE, MAKING IT A TOTALLY UNCONDITIONAL UNDERTAKING

There is no doubt that the law of fraud is applicable to restrain those who take advantage of others, especially those who are least able to protect themselves from fraudsters. But when a rule of law is specifically designed to protect one who is able to protect himself and brings detriment in terms of significant economic costs and time to a completely innocent party, that rule of law should be changed. Letters of credit are used by sophisticated businessmen and entities who have the resources to adequately protect themselves, either personally or through hired professionals. Issuers should not be required to be involved in disputes between the applicant and the beneficiary which could easily have been avoided or neutralized through proper drafting of documents.

Times have changed. What could have been justified in the dark ages of commercial transactions is no longer true. Assertions that the fraud exception plays a vital role in the commercial utility of letter of credits is a bold assertion, but the litigation time and economic costs associated with its application are too high. It is time for applicants of letters of credit to protect themselves, which is easier to do today with the sophistication of digital communications relating to financial information, especially in the case of commercial letters of credit. Thus, the author proposes that the payment obligation under a letter of credit be injunction proof leaving the disappointed applicant to seek redress from the beneficiary. While this may entail traveling across the world to litigate in an unfavorable venue and incurring the initial costs of litigation, it leaves the issuer/confirmer out of the litigation circle and allows them to do what they are fully competent to do—evaluate the risks

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<sup>250</sup> See *Jaffe v. Bank of Am., N.A.*, 395 F. App'x 583, 585 (11th Cir. 2010) (requiring a certified statement that the amount of the draft represents the unpaid balance of the loan due to ABC from Foshan); see also *2002 Irrevocable Tr.*, 2010 WL 11512368, at \*5 (stating that the draw request only had to represent the unpaid indebtedness due the Shenzhen by Foshan).

associated with issuing a letter of credit for a particular applicant and honoring a presentation that strictly conforms to the terms and conditions of the letter of credit. If in the remote chance that an issuer/confirmer acquires actual knowledge of a forged or fraudulent document in the presentation or has actual knowledge of material fraud in the underlying transaction, they can dishonor the presentation.

In order to achieve the result suggested by the author of this Article, Section 5-109 of the U.C.C. needs to be revised to read as follows:

(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but the issuer has actual knowledge that a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

(2) the issuer, acting in good faith, shall dishonor the presentation.

(b) A court of competent jurisdiction may not temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons.

These proposed changes to the Uniform Commercial Code will free the letter of credit from the meddling of courts in their perceived fairness which has impaired the usefulness of the letter of credit as a commercial vehicle to speed payment and shift knowable risks. The tether of the fraud exception will be gone, and the issuer will no longer have a conditional obligation to honor, but a totally unconditional, independent one. While this change would apply to both commercial letters of credit and to standby letters of credit, its

most significant impact will be in standby letters, in part because there is substantially less litigation on commercial letters than standby credits. These changes will force an applicant to think long and hard before entering into a clean letter of credit transaction and will perhaps lead to more negotiation among the parties concerning the nature of the documents that need to be presented for honor. A world that thinks ahead is better than one that waits until things turn sour.