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Legal Aspects of Letters of Credit and Related Secured Transactions

BORIS KOZOLCHYK*

I. INTRODUCTION: WHAT IS A COMMERCIAL LETTER OF CREDIT?

The focus of my presentation will be on the legal aspects of commercial letters of credit and particularly on some of the difficulties associated with their use across inter-American and international boundaries.

The first difficulty lies in properly identifying the instrument. Some lawyers, judges, and legislatures still mistakenly assume that a commercial or "documentary" letter of credit is the same instrument as the old or "traveler's" letter of credit. The traveler's letter of credit, an instrument which was extensively used from the eighteenth to the early twentieth century, only embodies the liability of the issuer, who is not, incidentally, the instrument's paymaster.¹ As indicated by its name, the traveler's letter of credit was designed to provide a traveler with funds in a foreign country. The instrument's paymaster or payor was usually a foreign nominee who was not liable on the instrument as he had neither co-signed it nor accepted the issuer's order or request of payment. Payment of the travelers' letter of credit then could not be enforced by its beneficiary-payee against the payor-nominee, but only against the issuer. If sued as the issuer's agent, the payor-nominee could validly defend himself by alleging that the issuer had failed to provide him with funds. The old or traveler's letter of credit, therefore, could not be an instrument involved in a very significant percentage of international, national, and local trade transactions.

The instrument required by modern international trade is of relatively recent vintage. It appeared during the second half of the nineteenth century in European and European-American trade and came into full use following World War I. It embodies a promise of

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1. For a brief description of the seventeenth century letter of credit referred to in the principal text as the "traveler's" letter of credit, see B. KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS* 5-7 (1966) (hereinafter referred to as Kozolchyk).

payment by a party of known solvency (usually a bank) either at the customer's (buyer-importer) or beneficiary's (seller-exporter) place of business, or in both places. In contrast with the traveler's letter of credit, an irrevocable-confirmed credit can be enforced against both the confirming bank in the beneficiary's place of business and the issuing bank in the customer's location. In addition, the promises of both the issuing and confirming banks, to use a term dear to civil lawyers, are "abstract" in nature. This means that, as a rule, they are independent from and can be enforced regardless of the equities in the underlying transactions.² A beneficiary need not worry that the customer did not pay the issuing bank the latter's commission for the opening of the credit, or did not provide the requisite collateral or prepayment. Once he has the irrevocable letter of credit in his possession, he can enforce the issuing or confirming bank's promise by merely complying with the terms of the operative instrument. Similarly, the issuing and confirming banks are precluded from raising defenses based upon the underlying transaction between the customer and beneficiary, except in extreme cases of fraud or the illegality of the transaction.³

Despite these clear differences and the disuse of the old or seventeenth century letter of credit, many commercial codes, especially in Latin America, have retained the rules applicable to the old *cartas ordenes de crédito*, and occasionally, lawyers and courts mistakenly apply these rules to the modern transaction. For example, one finds provisions in enactments purporting to deal with the commercial letter of credit, such as Article 317 of the Mexican negotiable instruments' law,⁴ or Article 899 of the Honduran Commercial Code,⁵ which expose the beneficiary of a Mexican or Honduran letter of credit to defenses based on the underlying buyer-seller or customer-issuing bank relationships. On the whole, however, there is a growing awareness in the commercial and legal communities of the key features of the modern or documentary letter of credit. In large measure, this awareness has resulted from the virtually universal incorporation of a set of rules known as the Uniform Customs and Practice for Documentary Credits (UCP) in the text of the commercial letter of

2. The subject of abstraction is discussed in greater detail, *infra* Section IV.

3. *Id.*

4. *Ley General de Titulos y Operaciones de Credito*, Diario Oficial de 27 de Agosto de 1932, arts. 317-20.

5. Código de Comercio de Honduras, 16 de Febrero de 1950.

credit.⁶ These rules, drafted and periodically revised by the International Chamber of Commerce, are not, despite claims to the contrary by their draftsmen,⁷ a Code, or even a systematic compilation of the rules that govern commercial letters of credit. They do embody, however, a consensus among international bankers, and to a lesser extent, among carriers and insurers as to what should be the basic principles and guidelines that should govern the handling of letters of credit and related documents by the banks.

The lack of technical or legal precision of UCP language can sometimes create unnecessary confusion on some of the key features of a commercial letter of credit. One such instance is Article 3, Section (a) of the 1974 Revision, presently in force.⁸ Section (a) of Article 3 of the UCP defines the irrevocable credit as: "a definite undertaking of the issuing bank, provided that the terms and conditions of the credit are complied with." Subsection (a)(3), however, includes within the scope of the irrevocable promise the issuing bank's obligation:

to purchase/negotiate, without recourse to drawers and/or bona fide holders drafts drawn by the beneficiary at sight or at tenor on the applicant for the credit or any other drawee specified in the credit, or to provide for the purchase/or negotiation by another bank if the credit provides for purchase/negotiation.

The first question prompted by this language is what is the obligational meaning of one bank's "providing" for another bank's purchase or negotiation? What is the beneficiary's remedy if the second bank refuses to purchase or negotiate? Secondly, since Article 3(a)(3) does not indicate what kind of purchase or negotiation it will be, i.e., with or without recourse on the drawer-beneficiary, can the second bank validly refuse to negotiate except with recourse on the beneficiary? The absence of such an indication is all the more noticeable by comparing the text of subsection 3 in sections (a) and (b). Subsection (b)(3) clearly provides that a confirming bank's purchase or negotiation of beneficiary's draft is without recourse in all instances in which

6. UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDIT (hereinafter referred to as UCP), *International Chamber of Commerce*, Publication 290, containing the 1974 revision presently in force.

7. See, e.g., *International Chamber of Commerce Brochure 222* at 3, referring to the 1933 customs as a "codification". See also F. EISEMANN, *LE CRÉDIT DOCUMENTAIRE* 75 (1963), referring to the International Chamber of Commerce as a work of "codification".

8. UCP, *supra* note 7.

purchase or negotiation is provided. Subsection (a)(3) expressly provides that the purchase/negotiation of drafts drawn on the applicant for the credit, or on any other drawee specified in the credit, is on a non-recourse basis, whereas with respect to the purchase/negotiation by "another bank," there simply is no indication whether the issuing bank will be responsible for it being on a nonrecourse basis. Conceivably, therefore, a credit could still be defined as irrevocable if it contained the issuing bank's promise that another bank acting as a purchasing or negotiating bank will purchase or negotiate a beneficiary's draft with recourse on the beneficiary. Such a credit, however, is only irrevocable in appearance and would definitely not be in a client's best interest, especially if the negotiating bank seeks recourse for a reason such as its failure to obtain reimbursement or prepayment from the issuing bank.

In answering the question of what is a commercial letter of credit, then, one should bear in mind not only the distinction between the old and the new letter of credit; it is also important to remember that what characterizes the "new" irrevocable letter of credit is the undisputed enforceability of its promise of payment (whether immediately or "at sight" or in time) upon the beneficiary's compliance with terms stated in the operative credit instrument. Accordingly, any subjection of such a promise to defenses arising from the underlying transactions between buyer and seller, or between the buyer and the issuing bank, or between the issuing or confirming bank is inconsistent with the nature of the instrument.

II. SOURCES OF LETTER OF CREDIT LAW

In keeping with my purpose of focusing on areas where the diversity of law can lead to operational difficulties, I will now turn to the question of what are the main sources of letter of credit law.

Only a small number of jurisdictions have enacted statutory law specifically applicable to commercial letters of credit. The Foreign Trade Code of Czechoslovakia, the Commercial Codes of Colombia, Guatemala, Honduras, Italy, Lebanon, Syria, and the United States, statutory rules in diverse commercial law enactments in the German Democratic Republic, Greece, and Mexico are the only statutory or quasi-statutory rules I found in a recently concluded survey for the *International Encyclopedia of Comparative Law*.⁹ Courts in most

9. Czechoslovakian International Trade Code, Act. No. 101 of Dec. 4, 1963; Colombian Commercial Code, arts. 1408-15 (1971); Guatemalan Commercial Code,

jurisdictions, therefore, rely on the Uniform Customs and Practice as either the law expressly chosen by the parties, or as the formal customary law applicable even if the parties, or, more accurately, the issuing or confirming banks, did not choose its application. Since such an exclusion is highly unlikely, as banks (almost invariably) incorporate the UCP as part of the letter of credit and use standardized credit forms drawn by the same International Chamber of Commerce with boiler plate which incorporates the UCP, the influence of the UCP in judicial decisionmaking throughout the world is paramount.

Writers, particularly in civil law jurisdictions, question whether certain UCP rules, such as those on timely compliance with the terms of the credit or on presentation of documents, should exclude explicit, although much broader civil code provisions, such as those on timely performance.¹⁰ In addition, courts both in common law and civil law jurisdictions have refused to apply the UCP's broadly gauged disclaimers of bank liability¹¹ where they come into conflict with the forum's "imperative" or "public policy" provisions. On the whole, however, and excepting instances of collision with the forum's public policy, most courts tend to regard the UCP as a fully fledged or "formal" commercial custom and not merely as a "contractual usage." Such a status makes it unnecessary to incorporate the UCP expressly into the operative instrument or instruments. Except in cases of unconscionability or of "abuses of rights," it does not require proof

arts. 758-65 (1970); Honduran Commercial Code, *supra* note 6, arts. 898-910; Lebanese Commercial Code, art. 313 (1942); Syrian Commercial Code, art. 418 (1949); German Democratic Republic, Law on International Economic Contracts of Feb. 5, 1970 (GBI, I, 61) Part 8, ch. 6; Greek Decree Law of July 17, Aug. 13, 1923 (Kd. Them. 582-92) arts. 24-34; Mexican LTOC, *supra* note 5. For a discussion of these sources, see Kozolchyk, *Letters of Credit*, in 9 INTERNATIONAL ASSOCIATION OF LEGAL SCIENCE, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW paras. 16-20 (to be published in 1979) (hereinafter referred to as Kozolchyk Encyclopedia).

10. See, e.g., LABANCA, NOACCO, AND VERA BARROS, *EL CRÉDITO DOCUMENTADO* 189-90, suggesting that Argentine courts should apply Argentine Civil Code art. 24 on the determination of time-lines of documentary compliance rather than the UCP.

11. Referring to the disclaimer of bank liability still present in art. 9 of the UCP, Shattuck and Guernsey, *Letters of Credit and the UCC*, 37 WASH. L. REV. 325, 357 n.63 (1962), conclude that: "The distaste of U.S. Courts for broad gauge exculpatory clause[s] suggest that an attempt to incorporate such a clause by reference may not work unless the beneficiary can be shown to have actual knowledge of the provision of UCP." Argentine and Brazilian courts have rejected UCP provisions which tended to operate as broad disclaimers of the banks' liability for faulty verification of documents. See, e.g., the decision by the Argentine Camara Nacional de Apelación Comercial, Cap. Fed. Oct. 2, 1950, JURISPRUDENCIA ARGENTINA 1952 II, 233; and the Brazilian, Ap. Civ. São Paulo, Oct. 27, 1950, Rev. Trib. São Paulo 190 (1951).

of the parties' awareness of the meaning of the UCP. On the other hand, this status does not preclude the parties' express exclusion of the UCP as a governing source.¹² In the United States, the UCP's interaction with the Uniform Commercial Code (UCC) has given rise to some interesting "source of law" decisions. It is clear that where there is an inconsistency between UCC and UCP provisions, such as on the presumption of revocability or irrevocability, when letters of credit are silent on the point, the court will rightfully (except in a jurisdiction such as New York where the UCP has by statute preeminent application) apply the UCC rule.¹³ It is also clear that whenever possible, courts in the United States will avoid reading the UCP and UCC provisions in a conflictive light. Whenever possible, the UCP rule will be applied in a manner complementary to the UCC, and in the absence of a UCC rule, the UCP will be allowed to fill the gap as a binding local banking custom or usage of trade.¹⁴

There are sound conceptual reasons for such a harmonious view of the UCC-UCP interaction. The UCC is, by far, the legislative enactment that most closely reflects contemporary letter of credit practices. In addition, Article 5 of the UCC is, on the whole, a well-crafted enactment. It combines technical or purely legal concepts, such as those underlying the remedies for the various types of breach, with "living law" rules derived from widely followed banking practices.

The contrast between the UCC and other legislative enactments is apparent at first sight. For example, not only does an enactment such as the Mexican LTOC espouse a principle which is totally inconsistent with the nature of the modern letter of credit,¹⁵ but even its basic terminology is mistaken and confusing. The Mexican LTOC

12. Maurice Megrah, the highly respected British practitioner and scholar makes the point clearly in H.C. GUTTERIDGE and M. MEGRAH, *THE LAW OF BANKERS' COMMERCIAL CREDITS* 7 (1976).

13. See, e.g., *West Virginia Housing Dev. Fund v. Sroka*, 415 F. Supp. 1107 (W. D. Pa. 1976), where a credit silent as to its revocability was, contrary to the 1974 UCP Art. 1, deemed irrevocable. It should be noted that the credit transcribed in the report contained no reference to the UCP, and consequently, the Court's application of UCC Art. 5 and of "normal principles governing interpretation of contracts" was not the product of a choice between two contradictory provisions.

14. See, e.g., *AMF Head Sports Wear, Inc. v. Ray Scott's All Am. Sports Club, Inc.*, 448 F. Supp. 222 (D. Ariz. 1978), where the UCP was applied as local banking custom, although the court suggested that it might consider proof of the local banking usage contrary to that incorporated in the UCP if such proof was tendered.

15. See notes 5 and 6, *supra* and accompanying text.

labels the irrevocable letter a "confirmed" credit, regardless of whether it was truly confirmed. Such a terminology can only lead to the conclusion that an irrevocable unconfirmed letter of credit is likely to be treated as irrevocable-confirmed by the LTOC. *Mutatis mutandis*, Article 1414 of the Colombian Commercial Code provides, in a manner equally inconsistent with the nature of the confirmation, that the confirming bank will be liable "on the same terms" (*en los mismos términos*) as the issuing bank. Thus, it is in direct contradiction with both the 1974 UCP Article 3(b) which describes the confirming bank's liability as one "in addition to the undertaking of the issuing bank" and with UCC § 5-107 (2) which describes the confirming bank's liability as dependent upon "the extent of its confirmation."

I would be unjust to my own trade if, in concluding this section, I would not call attention to the significant influence that doctrinal writing has had in shaping letter of credit law in important trading centers. Books such as Gutteridge and Megrah's, *The Law of Bankers' Commercial Credits*, Ward and Harfield's, *Banks Credits and Acceptances*, and more recently Henry Harfield's fifth edition of the same book, have been quite influential in Anglo-American and even in some civil law jurisdictions. Similarly, J. Stoufflet's *Le Crédit Documentaire*, J. Zahn's, *Zahlung and Zahlungssicherung im Aussenhandel*, C. E. Balossini's, *Norme Ed Usi Uniformi Relativi Ai Crediti Documentari*, Labanca, Noacco y Vera Barros, *El Crédito Documentado*, have shaped French, German, Italian, and Argentine law, respectively. The reason why doctrinal writing is so uniformly influential in this area of the law is twofold: first, judges frequently need a "legal" explanation of banking and commercial practices; second, the merchants' inability to formulate sound or generally applicable law requires that many of the "banking" customs be formulated by "outsiders," such as doctrinal writers.¹⁶

16. The problem alluded to in the principal text is not only that of a technically deficient text of customary rules, but of one-sided rules, or rules which treat regular participants in the transaction, such as banks, in a highly favorable or "brotherly" manner and treat occasional participants, such as an importer, exporter, or consumer, in an unfavorable or "stranger" like fashion. I have discussed these standards and their role in commercial law making in a recent article; Kozolchyk, *Fairness in Anglo and Latin American Commercial Adjudication*, 2 B.C. INTL. & COMP. L. REV. 219 (1979); and also in the 1979 Tucker Lecture at the Louisiana Law Center, to be published in the Fall 1979 issue of the Louisiana Law Review.

III. THE ISSUING BANK-CUSTOMER RELATIONSHIP

A. Contract or Quasi-Contract

The important comparative law datum in this, the first chronological relationship in the letter of credit transaction, is its diverse characterization in U.S., European, and Latin American banking law. From a United States standpoint, unless the bank specifically commits itself to issuing a letter of credit and charges a commitment fee, or otherwise complies with the contractual consideration requirement, it is not bound to issue the letter of credit. The customer's application for the issuance of a credit, despite the occasional label as "application-agreement," and despite the occasional stamp or signature of acceptance by the bank, is only an application and not an agreement. It is not a bilateral contract binding on the bank.

Experienced U.S. bankers will quickly explain that there are good reasons for such an indefinite state of affairs at this early stage of the letter of credit transaction. Experience has shown both United States and British bankers that in many credits the beneficiary's solvency and reliability are as important as the customer's. Frequently, just before issuance, some information indicating the probable inability to obtain reimbursement from the customer or valuable collateral from the beneficiary may come to the issuing bank's attention. Consequently, he tries to be as "flexible" in his promise or undertaking to the customer as possible. In this sense, the relationship between the customer and the issuing bank is quasi-contractual, or one where liability is triggered by the actual rendering of the bank's service of issuance, or the payment of the credit.

By contrast, many civil law jurisdictions, especially in Latin America, characterize the issuing bank-customer relationship as contractual and binding on the issuing bank from the moment of execution of the contract of "opening of credit."

This contract, frequently depicted as onerous, bilateral, and synallagmatic provides a cause of action for the customer who, having fulfilled or standing ready to fulfill his side of the bargain, is nevertheless met by the issuing bank's refusal to issue a credit. To be sure, the opening of a credit agreement usually stipulates that if a condition subsequent supervenes, such as the customer's or beneficiary's insolvency, the contract can be rescinded by the bank without incurring liability. The presence of such a condition subsequent should not prompt the conclusion that the difference between the United States and the Latin American approach is purely nominal. A U.S. bank

may well decide for causes other than those in the condition subsequent of the opening of credit agreement, not to go ahead with the issuance, and would be protected in doing so by the quasi-contractual approach. Accordingly, an American customer who must be able to count on the bank's issuance should avail himself of the bank's commitment mechanism. A firm commitment is usually obtained from the bank upon the customer's payment of a commitment fee.

B. Issuing Bank's Security

An Anglo-American issuing bank can resort to several informal and flexible transactions when attempting to secure its customer's payment or reimbursement of the issuance. Prior to the issuance, the issuing bank usually obtains a security agreement from the customer. This agreement, occasionally referred to as a "letter of hypothecation" by British banks, conveys through the seller a security interest on the documents of title, merchandise, and proceeds of the sale thereof to the issuing bank. This conveyance takes place at a time prior to the bank's possession of any of the above described collateral. In some instances, it is supplemented by a "blocked account" stipulation, whereby the customer's funds on deposit in his account with the issuing bank are set aside, segregated, or earmarked for the purpose of payment of the issuance. Alternatively, or in addition to the blocked account, a customer may be required to deposit valuable and liquid or highly marketable collateral with the bank. Formalities are minimal in these agreements, and the security interest in the documents of title, merchandise, and proceeds is "perfected" during a period of twenty-one (21) days in accordance with UCC Article 9 without having to file the customary financing statement.¹⁷ If the customer cannot repay the bank upon the arrival of the goods, the bank can release the documents of title to the customer upon the latter's signing a "trust receipt." The trust receipt empowers the customer to store, warehouse, work upon, or even sell the goods, but impresses the proceeds of such a sale with the bank's ubiquitous security interest.¹⁸ As with the initial security agreement, the trust receipt security interest

17. UCC § 9-304(4) (1978 Official Text) provides for temporary perfection of the bank's security interest, without filing or possession, for twenty-one days from the time the interest attaches (execution of the security agreement or letter of hypothecation) to the extent that it arises for new value given by the issuing bank in connection with the security agreement.

18. For a discussion of the trust receipt in connection with the letter of credit transaction, see Kozolchik, *supra* note 1, at 155-89.

can be temporarily perfected (during twenty-one days) without the filing of the agreement or financing statement.¹⁹ I hasten to add for the benefit of my civil law readers that despite its name, the trust receipt is not a legitimate heir of the common law real property trust. The trustee's legal title is not derived from the bank-entruster but from the seller-beneficiary of the letter of credit transaction. In addition, the bank is both an entruster and beneficiary in the trust receipt transaction. The nature of the trust receipt, therefore, is that of a personal property secured transaction much as is a chattel mortgage or a condition sale. Indeed, the trust receipt was designed to overcome some of the problems posed by these personal property secured transactions when used in conjunction with letters of credit. Thus, a trust receipt that had not been recorded could still be deemed perfected, albeit for a limited period of time, without suffering invalidation as a "secret lien".²⁰ In addition, through the "tracing" mechanism, the trust receipt affects successive generations of proceeds, such as negotiable instruments obtained in payment of merchandise, cash in payment of negotiable instruments, and merchandise acquired with such cash or negotiable instruments.²¹

In contrast, secured transactions in civil, and especially Latin American, law jurisdictions require greater formality and provide less security to the issuing bank. For example, in El Salvador, the creation of the bank's security interest on the documents of title and merchandise requires the execution of a contract of "opening of documentary credit".²² In even sharper contrast with prevailing views in Anglo-American jurisdictions, a Chilean banking law authority suggests the need for formal pledge agreements to precede or accompany the beneficiary's endorsement or delivery of documents of title to the bank in order to perfect the latter's security interest.²³ In addition to the constraints imposed by greater formality at the creation stage, the bank's right at the time of realization of the security

19. See UCC § 9-304(5) (a) and (b) (1978 Official Text).

20. Kozolchyk, *supra* note 1, at 158-62.

21. See UCC § 9-306 (1978 Official Text).

22. Art. 1125 of the Commercial Code of El Salvador predicates the issuing bank's obligation to the customer on the delivery of documents which will serve as the issuing bank's collateral, per the contract of opening of credit.

23. See J.C. VARELA MORGAN, *EL ACREDITIVO* 87 (1960). According to this author, Art. 815 of the Chilean Commercial Code of 1865 provides that the pledge's preference over other secured and unsecured claims requires a public deed or a private but notarized writing. He concludes that since banks do not adhere to such formalities they are not truly protected by the pledge type of security.

interest in many Latin American jurisdictions are similarly curtailed. Since Latin American lawyers, as a rule, adhere to the notion that ownership or ownership-like rights can only be created by a limited number of juristic acts or transactions, such as adverse possession, inheritance, or contract of sale, and since secured transactions are not among these, the bank, as a secured creditor, cannot act as an owner with respect to the collateral. This restriction impedes the bank's power of disposition over the merchandise as holder of the documents of title or even as the party in rightful possession of the merchandise. A stipulation allowing the banks such power of disposition upon the customer's default is usually tagged with the ominous sounding label of *Pactum Commissorium* and is held to be illegal.²⁴ Thus, a provision such as Article 111 of Mexico's General Law of Banking Institutions, which authorizes the bank's private sale of the merchandise upon its own (as contrasted with a judicial) determination of default, is still an exceptional provision in Latin American jurisdictions.²⁵ The informal, broad, and flexible powers granted to the issuing bank as a secured creditor by the West German "General Terms and Conditions of Banking"²⁶ are still foreign to banking law and practice in the majority of Latin American jurisdictions.

24. On the *Pactum Commissorium*'s relation to the issuing bank's security, see Kozolchik, *supra* note 1, at 126 n.14, 137.

25. For a comment on Art. 111 of the Mexican *Ley General de Instituciones de Crédito y Organizaciones Auxiliares*, *Diario Oficial* Mayo 31, 1941, see Kozolchik, *supra* note 1, at 128-29. For a comment on the Argentine Commercial Code's Art. 585, a similarly exceptional provision, see *id.* at 125-27.

26. See, e.g., *Allgemeine Geschäftsbedingungen* (General Business Conditions of German Banks, English translation supplied by Dresdner Bank) April 1977 version which, in relevant sections provide:

19. (1) The bank is entitled at any time to request its customer to provide or increase security according to banking practice for all liabilities, even if they are conditional or unmatured. (2) Any things and rights, including claims of the customer against the bank, which have in any way come or may come into the possession of any office of the bank or of which it may be able to dispose, shall serve as pledge for all existing and future claims—including conditional or unmatured claims—of the bank against the customer. Such pledge shall also apply to claims against the customer, which may pass to the bank from third parties and to claims of the bank against firms for whose obligations the customer is personally liable. It makes no difference whether the bank has obtained direct or indirect possession, or actual or legal power to dispose of such things and rights. 20. (1) If the customer fails to meet his obligations at maturity, the bank shall be entitled to realize such security without legal proceedings at any time at any place which it may deem appropriate, either at once or from time to time, while making allowance for the interests of the customer as far as

With the exception of Brazil's Law No. 4.728 of 1965, which authorized the use of trust receipts (*alienação fiduciária en garantia*),²⁷ most civil law jurisdictions lack a statutory basis for the enforcement of the bank's rights as a trustee upon the release of the documents of title to its customer. Mistakenly, the vast majority of writers in civil law jurisdictions equate the absence of an express statutory approval of trust receipt-like transactions with a systemic disability to use an equivalent device. This is in large measure the result of assuming that the trust receipt security interest is predicated on the ability to fragment title into legal and equitable components, as in the common law trust. The fallacy of such a view is apparent by examining the operation of Germany's *Sicherungsübereignung*, a security device which is the trust receipt's functional counterpart and which does not require or presuppose a fragmentation of the ownership of documents of title, merchandise, and proceeds thereof.²⁸

IV. THE LEGAL NATURE OF THE ISSUING OR CONFIRMING BANK-BENEFICIARY RELATIONSHIP

Although the relationship between the issuing and confirming banks and the beneficiary is commonly referred to as "contractual,"

possible. Where there is more than one security, the bank may choose between them. It may first seek to obtain satisfaction from other assets of the customer. The bank will provide the customer with a credit advice concerning the proceeds, such advice being admitted as invoice for the delivery of goods serving as security and meeting the requirements of the turnover tax law (*Umsatzsteuerrecht*). (2) No notice of realization need be given, nor need any time limit be observed, nor need the purchase price be immediately payable in cash. No deviation from the regular method of sale of pledged security can be demanded by the customer. The bank will as far as possible give notice of the method, place and time of realization, provided such a notice is not considered inappropriate.

27. See Lei No. 4, 728 de 14 de julio de 1965, *Mercado de Capitais*, Art. 66.

28. J. ZAHN, *ZAHLUNG UND ZAHLUNGSSICHERUNG IM AUSSENHANDEL* 177 (5th ed.) describes the *Sicherungsübereignung* as follows:

As in German law a valid pledge requires continued possession of the goods so that their delivery to the pledgor destroys the pledge . . . the security will have to be furnished by way of a security transfer of ownership In order to preserve the continuity of its security, the bank must ensure that the ownership in the documents and therefore—where negotiable documents of title are issued—also the property of the goods is transferred directly from the beneficiary to the bank, without first passing to the buyer. [Translation supplied by the staff of the Max Planck Institute for Private International and Comparative Law, Hamburg.]

For a full discussion of the possibility of adapting the trust receipt mechanism in civil law jurisdictions see Kozolchyk *Encyclopedia*, *supra* note 9, at paras. 121-25.

there is no contract, in the strict sense of the term, between the beneficiary and the banks. It is even less possible to rely on contract law concepts such as mutuality of promises or consideration to explain the nature of the bank's liability to the beneficiary. The beneficiary neither pays nor promises anything to the banks in return for their promises of payment. He is not bound to "use" the credit and, where banks are concerned, he can safely ignore their issuance of confirmation. Moreover, the banks' irrevocable promise to the beneficiary is valid and binding regardless of whether there was consideration for it, or whether consideration could be connected in some manner with the beneficiary or with his actual or imputed agent.

The issuing and confirming banks' promises to the beneficiary of an irrevocable letter of credit is a formal and abstract promise of payment. It is formal in the sense that it must be in writing and must contain certain customary expressions such as "we engage" or "we promise" or "undertake." In addition, some terms are essential, such as a maximum amount, a period of expiry, and a credit number.²⁹ It is abstract in the sense that it is independent of underlying equities between the parties. For example, there may be a genuine failure of consideration between the buyer and the seller as a result of the latter's shipment of defective merchandise; the buyer may have failed to provide the issuing banks with funds for the issuance of the credit, or the issuing bank may have failed to provide funds to the confirming bank. Yet, both the issuing and confirming bank are bound to pay the credit upon beneficiary's compliance with its terms.

The concept of an abstract promise or obligation, incidentally, is not peculiar to letter of credit or even to negotiable instruments' law. Its function is to encourage third parties' reliance on certain legally

29. The subject of the formalities of the letter of credit is covered extensively in Kozolchyk Encyclopedia, paras. 170-181. A useful, although incomplete, listing may be found in Comptroller of the Currency Interpretive Ruling 60,906 of May 9, 1977, FED. BANKING L. REP. (CCH) 38,887:

As a matter of sound banking practice, letters of credit should be issued in conformity with the following: a) each letter of credit should conspicuously state that it is a letter of credit or should be conspicuously entitled as such; b) the bank's undertaking should contain a specified expiration date or be for a definite term; c) the bank's obligation to pay should arise only upon presentation of a draft or other documents specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary; d) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit. (As amended effective May 12, 1977, 42 Fed. Reg. 24206 (1977)).

sanctioned "appearances," whether such an "appearance" is a formal private party promise or an official or governmental certificate. In fact, abstraction is pervasive in the law of property where it is used to protect the purchaser of personal and real property from infirmities in his chain of title, especially when he relies on a sanctioned appearance of title, such as the grantor's possession or a recording in his name. In this respect, the promise of the issuing and confirming bank has a great deal in common with a certificate of ownership issued by a land registrar in jurisdictions where such a certificate assures an undisturbed enjoyment of title.

The principle of abstraction, which the UCP enunciates proverbially as "banks are concerned with documents and not with goods,"³⁰ requires that the banks examine the documents in a similarly abstract fashion. The banks must ascertain that the documents submitted by the beneficiary *on their face* comply with the terms of the credit, and unless required by the terms of the issuance, they should refrain from determining the veracity or accuracy of what is stated in the documents.³¹ The standard for judging compliance is strict. In fact, the judicial principle that governs the bank's examination of documents is referred to as one of "strict compliance." As stated in 1927 by Lord Sumner in *Equitable Trust Co. of New York v. Dawson Partners*, "there is no room for documents which are almost the same, or which will do just as well."³²

The perennial question that both experienced bankers and judges must ask themselves, however, is how strict must strict compliance be? If the invoice is required to describe the merchandise as "hydrogen peroxide," is it defective if it is described instead as H₂O₂? Moreover, in light of the stated requirement of inter-documentary consistency,³³ should the bank reject a bill of lading that, in contrast with the invoice which describes the shipped statue as the "Venus of Milo," describes it as "a badly damaged statue?"³⁴ Please note that in

30. See 1974 UCP Art. 8 (a): "In documentary credit operations all parties concerned deal in documents and not in goods"; see also General Provision: "Credits, by their nature, are separate transactions from the sales or other contracts on which they may be based and banks are in no way concerned with or bound by such contracts."

31. 1974 UCP Art. 7.

32. [1927] 27 Lloyd's List L.R. 42.

33. 1974 UCP Art. 7 states: "Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit."

34. Letter of credit students owe this excellent example to Professor John Honnold; see Honnold, *Letters of Credit, Custom, Missing Documents and the Dixon Case*, 53 COLUM. L. REV. 504, 507 (1953).

the first of the preceding illustrations the discrepancy is nonexistent, as the terms have exactly the same meaning. Also, note that in the second illustration, the discrepancy results not from a factual difference, as the shipped object is the same, but from the different nature of the respective documents. The invoice reflects the seller's description of the merchandise, and as the old Spanish saying goes, "the master's eye fattens the cow," whereas the bill of lading reflects the carrier's concern not to be responsible for damages suffered by the merchandise while under his care. Accordingly, even though their descriptions differ, they are not necessarily inconsistent. In addition, certain discrepancies may be cured by custom-inspired devices, such as letters of indemnity,³⁵ while others, such as in the hydrogen peroxide illustration, are truly insignificant.

Despite the insignificance of these deviations, customers have a known propensity to insist that they are indeed significant whenever the price of the merchandise suffers a drastic drop, or other circumstances indicate that they are likely to suffer a severe loss if required to pay for the amount of the credit. Courts in developed trading centers are generally aware of such a propensity, and consequently, tend to take the issuing banks' objections to beneficiary's compliance more seriously when raised by the issuing bank than those of the customers when raised against the issuing or confirming banks' acceptance or payment.³⁶

Conversely, however, a beneficiary may decide to take advantage of the abstraction of the letter of credit promise and of the principle of strict compliance by submitting documents that on their face comply with the terms of the credit, but which in fact are forged or fraudulent. The judicial question then becomes whether to adopt a formalistic attitude and disregard the substance of the transaction, tainted as it is with fraud, or to grant an equitable remedy, such as an injunction against beneficiary's presentation of documents and drawing on the credit, or against acceptance or payment, by the issuing or confirming bank.

Letter of credit law is presently suffering what Henry Harfield, one of the United States' most distinguished banking lawyers, with characteristic poignancy has described as an injunction epidemic. In significant measure, this is the result of the increased use of the so-called "standby credits." These credits are not used to pay for title-

35. See Kozolchik, *supra* note 1, at 432-43.

36. *Id.* at 264-66.

passing transactions, but to assure beneficiaries compensation in the event the customer does not perform according to the agreed-upon terms in the underlying transaction. Frequently, the beneficiary can obtain payments of huge sums by merely stating or certifying that he is entitled to them.

It is true that in the standby credit, as in other types of commercial letters of credit, the bank does not concern itself with the underlying performance, but with the documents which refer to it, and that its function is to ascertain that the documents, and solely the documents, comply with the terms of the credit. In this sense, it is correct to draw the line between having to ascertain the occurrence of an event or the existence of a fact which is, in principle, foreign to the bank's function, and the documentary representation that the event has happened, which is the bank's role to verify. Nevertheless, the line between verifying reality and its representation is not as neat as one would like it to be.

Assume, for example, that government A has requested from weapons supplier B, a private party in country C, to supply a standby credit to compensate government A for B's breach or improper performance, so that if the weapons are unsatisfactory, A would be compensated for damages. The standby credit would be paid then merely upon A's presentation to the issuing or confirming bank of a certificate indicating that B had failed to carry out his obligation under the weapons supply agreements.³⁷

Assume further that as a result of A's war with a neighboring country, C decided to embargo arms shipments to A. A presented a certification that B had failed to carry out its obligations, even though B had not breached its sales warranties and was ready to ship the ordered weapons as per A's order once C's embargo was lifted. Is A's representation of contractual default merely a representation, or is it a fraudulent distortion of fact, especially since the words used to represent the occurrence of the event triggering payment were totally out of contractual context? Should the issuing bank, although aware of the different context in which words were to be used in the certification, simply ignore the distortion?

Let me illustrate the role of the context of the words in a certification further by providing the following not very unlikely hypothetical

37. The factual situation described in the text is based upon the description of facts in *Dynamics Corp. of America v. Citizens & Southern National Bank*, 356 F. Supp. 991 (N.D. Ga. 1973).

situation. Assume that an Iranian importer of French liquor obtained a standby credit payable upon his or his successor in interest's certification of "undrinkability." Assume further that his successor in interest happens to be the present revolutionary government, and that as part of an exalting and purifying religious exercise, the liquor in question, without ever being tasted, is publicly disposed of in the most dramatic of fashions, including gestures of condemnation, in the presence of Western world television cameras. Should a bank which is aware of such an exercise pay the standby credit upon the Iranian government's certification of "undrinkability?"

As in many other instances, the extraordinary commercial law intuition of Justice Cardozo pointed to the absurdity and injustice of accepting a fraudulent or context-distorting document as *the* document required by the credit. As Justice Cardozo inquired in his dissent in *O'Meara Co. v. National Park Bank*³⁸: Can the tender of false documents be regarded as in compliance? Moreover, should the principle of abstraction, designed as it is to protect third parties who act in good faith, be invoked by a beneficiary who does not act in good faith? Are there not valid grounds for distinguishing between the third party status of a beneficiary who submits fraudulent documents, and that of a bona fide purchaser of his draft which grants the protection of abstraction to the latter but not the former? This was another question implicit in Justice Cardozo's *O'Meara* dissent. It was responded to in the affirmative in the landmark decision on letter of credit injunctions, *Sztejn v. J. Henry Schroeder Banking Corporation*.³⁹ The *Sztejn* Court adopted Cardozo's view that when the issuer of the letter of credit knows that a document, though correct in form, is in fact false or illegal, he cannot be called upon to recognize such a document as complying with the terms of the credit. The Court warned, however, that if it appeared that the bank presenting the documents and draft for payment was a holder in due course, its claim could not be defeated, even though the primary transaction was tainted with fraud. Thus, the *Sztejn* Court recognized with Justice Cardozo that equity, as has been the case through the history of the law merchant, was no stranger to the law of letter of credit transactions.

In the ensuing decades since the *Sztejn* decision, courts in the United States and Great Britain have clarified and broadened several

38. 239 N.Y. 386, 146 N.E. 636 (1925).

39. 177 Misc. 719, 31 N.Y.S. 2d 631 (1941).

important injunction-related issues. Among these are the scope and role of temporary restraining orders, the time within which a temporary restraining order or a preliminary injunction must be sought, the seriousness of beneficiary's alleged fraud, and the issuing bank's rights and duties when notified of actionable fraud.⁴⁰

By contrast, most continental European and Latin American courts are much more restricted in their use of injunctive relief. A procedural device which serves as a counterpart of the Anglo-American injunction in letter of credit litigation is the Belgian and French *Saisie Arrêt* and the Italian *Sequestro Guidizario*.⁴¹ Yet, since these are essentially attachment procedures, the petitioner-customer not only has to allege fraud (an allegation whose elements are far from being clear in continental European and letter of credit law), but he must also prove that he has a valid claim, or the basis of a valid claim as to the amount of money sought to be attached or sequestered.

This poses a vexing problem of legal logic, for the greater the likelihood of beneficiary's fraud, *pari passu* the customer's claim upon the funds in the bank's possession. In other words, the petitioner, as a *saisie arrêt* or *sequestro guidizario*, must show that he has a valid claim to funds in deposit with a stakeholder, which in our case is the issuing or confirming bank. But the letter of credit funds are only claimable or only susceptible to appropriation by the beneficiary or his creditors when the creditor-petitioner can prove that the beneficiary himself has a valid claim to the funds in deposit with the bank. Yet, this assumption is contradicted by the customer's own allegation of beneficiary's fraud. If the beneficiary has no valid claim to the funds in deposit with the bank because of his own fraud, how can the customer who is trying to attach the proceeds of beneficiary's claim succeed in his attachment?

40. On the scope and role of the temporary restraining order in English letter of credit law, see *Hamzeh Malas & Sons v. British Imex Industries, Ltd.*, [1958] 2 Q.B. 127 (C.A.). On the timeliness of an injunction procedure see *Tranarg, C.A. v. Banca Commerciale Italiana*, 90 Misc. 2d 829, 396 N.Y.S. 2d 761 (1977). On the elements of the allegation of fraud see *Dynamic Corp.*, *supra* note 37, and compare *West Virginia Housing Dev. Fund*, *supra* note 13. On the effect of notice of fraud to the bank, see *Shaffer v. Brooklyn Park Garden Apts.*, 250 N.W.2d 172 (Minn. 1977). For a discussion of these and other decisions clarifying the various elements of an injunction procedure, see *Kozolchik Encyclopedia*, paras. 217-32.

41. For a comparison of the Belgian, French, and German procedural devices with the Anglo-American injunction see *Kozolchik Encyclopedia*, *supra* note 9, at paras. 227-32.

In addition to these logical problems, the *saisie arrêt* and the *sequestro* presuppose that the issuing bank has set aside or will set aside funds for the payment of the credit, and that such payment will be impeded by the attachment of such funds. Thus, it may be ineffective against the act of acceptance of beneficiary's draft, which postpones the payment of funds until the date of the draft's maturity, and it may also be ineffective against the claim of the holder of the acceptance if he is someone other than the beneficiary himself. Presumably, the customer would have neither a valid claim nor the basis of a valid claim against such a third party.

The Anglo-American injunction, then, is a much more flexible and efficient device for the prevention of beneficiary's fraud and for the corrections of excesses of abstractions and strict compliance than is the *saisie arrêt* and the *sequestro guidizario*. Unlike other students of letters of credit law, I am not terribly disturbed by its availability. I am aware of the point of view that the injunctive relief can render the irrevocable letter of credit promise highly uncertain, but I do not share it. On the contrary, a comparative law examination of commercial law-making in developed and underdeveloped market economies leads me to conclude that certainty and predictability in commercial lawmaking is in large measure the result of tailoring official or "positive" law to the sense of fairness of the participants in market transactions.⁴² I have found that the most widespread standard of fairness in commercial law adjudication in developed market economies is one in which the prevailing rules of law are those which echo the manner in which most market participants treat each other when viewing their own advantage.

Clearly, such a standard is incompatible with a rule which requires that banks, even though aware of a fraud or forgery, ought nevertheless to pay the person perpetrating it. Such a rule could only be justified if the ordinary participants in the letter of credit transaction were willing to reward the swindlers among them. Even if it is true that standby credits (which as indicated earlier are the most susceptible to allegations of fraud) may not be as freely requested or issued, this may not be such an undesirable development. The

42. Kozolchyk, *Toward a Theory of Law in Economic Development: The Costa Rican USAID-ROCAP Law Reform Project*, 1971 LAW & SOC. ORDER 681, 710-3; see also Kozolchyk, *Commercial Law Recodification and Economic Development in Latin America*, 4 LAW. AM. 189, 192 (1972); Kozolchyk, *Fairness in Anglo-American and Latin American Commercial Adjudication*, 2 B.C. INTL. & COMP. L. REV. 219 (1979).

parties' hesitation to obtain the issuance of a standby credit because the beneficiary's representation may possibly be scrutinized by a court could well prevent the issuance of standbys where the parties had never truly agreed on what constituted proper performance of the underlying transaction. Thus, in addition to preventing the perpetration of fraud, it would force the parties' lawyers to employ their best drafting skills.