NEW YORK LAW SCHOOL

NYLS Journal of International and Comparative Law

Volume 8
Number 2 *VOLUME 8 NUMBER 2 SPRING 1987*

Article 5

1987

LETTERS OF CREDIT: DOUBTS AS TO THEIR CONTINUED USEFULNESS

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NOTE

LETTERS OF CREDIT: DOUBTS AS TO THEIR CONTINUED USEFULNESS

I. INTRODUCTION

The letter of credit can be an extremely useful device for facilitating complex international and domestic business transactions.[1] Although issued in a great variety of forms,[2] the modern letter of credit may basically be defined as a written instrument, issued by a bank or other financial institution,[3] in which the issuer promises to honor drafts presented by the specified beneficiary in compliance with the terms of the credit.[4] The customer requesting the bank to issue the letter of credit in turn promises to reimburse the issuer and pay it a

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1. Letters of credit have played a major role in the financing of trade goods, at least since the twelfth century, and perhaps as far back as the time of the Phoenicians, Babylonians, Assyrians, and Greeks. Wiley, *How to Use Letters of Credit in Financing the Sale of Goods*, 20 BUS. LAW. 495 (1965). In recent years, as much as ninety percent of the United States' merchandise imports have been financed by letters of credit. W. HAWKLAND, 2 A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 791 (1964).

2. The forms that a letter of credit can take are as varied as the transactions to which they are adapted. In addition to basic sales contracts, letters of credit are used as adjuncts to construction contracts, corporate consolidations and the issuance of commercial paper. They are also used instead of, or in connection with, bid and performance bonds, escrow accounts, stock transfers and purchases, and leases of real and personal property. Even the common charge card has been said to be no more than a plastic letter of credit. Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C.L.J. 251, 252 (1972).

3. "Although letters of credit are commonly thought of as being issued by banks and private bankers, other financing institutions can and do enter into transactions which fit the traditional concept of letters of credit." Uniform Commercial Code [hereinafter U.C.C.] § 5-102, Comment 1 (1976).

4. *See generally* H. HARFIELD, BANK CREDITS AND ACCEPTANCES 180-84 (5th ed. 1974). The Uniform Commercial Code, defines "credit" or "letter of credit" as an "engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. . . ." U.C.C. § 5-103(a).

commission for issuing the credit.[5]

This note will discuss the future of the letter of credit in the commercial setting. Doubts as to their continued usefulness stem from the increasing willingness of courts to look beyond the letter of credit contract to the underlying transaction.[6] First, this note examines the operation of the letter of credit in general terms,[7] then proceeds to explain the difference between the commercial (traditional) letter of credit and the standby letter of credit.[8] Further, this note looks at how the Uniform Commercial Code deals with letters of credit and how the "fraud" exception to honoring a letter of credit has become more of a "rule" than an exception.[9] Finally, the note attempts to make recommendations for the future,[10] to assure that the letter of credit maintains its continued usefulness in complex commercial transactions.

II. FUNDAMENTALS OF LETTERS OF CREDIT

The basic letter of credit arrangement involves three parties: the issuer, the customer, and the beneficiary.[11] These parties are engaged in three contractual relationships.[12] The first contract is the "underlying transaction," between the customer, the person applying for the letter of credit[13] and the beneficiary, the party to whom the letter is issued.[14] Usually, this contract involves a promise by the customer to pay a certain sum to the beneficiary[15] incident to either a sales transaction or a service contract.[16] The second is the contract between the issuer[17] and its customer whereby the issuer agrees to issue the letter of

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5. For a thorough discussion of the letter of credit and its mechanics *see infra* notes 11-35 and accompanying text.

6. *See infra* notes 57-70, 112-57 and accompanying text.

7. *See infra* notes 11-24 and accompanying text.

8. *See infra* notes 25-35 and accompanying text.

9. *See infra* notes 84-111 and accompanying text.

10. *See infra* notes 158-67 and accompanying text.

11. *See* U.C.C. § 5-103 (1)(a).

12. *See, e.g.*, Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464-65 (2d Cir. 1970); Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 995 (N.D. Ga. 1973).

13. A customer is defined as "a buyer or other person who causes an issuer to issue a credit. The term also includes a bank which procures issuance or confirmation on behalf of that bank's customer." U.C.C. § 5-103 (1)(g).

14. A beneficiary is defined as a "person who is entitled under [the letter of credit] to draw or demand payment." U.C.C. § 5-103 (1)(d).

15. *See* H. HARFIELD, LETTERS OF CREDIT 1-2 (1979).

16. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-1, at 708-09 (2d ed. 1980).

17. The "issuer" is defined as "a bank or other person issuing a credit." U.C.C. § 5-103 (1)(c). The issuer's obligations to the customer are detailed in Section 5-109, and the obligations owed to the beneficiary in Section 5-114.

credit to the beneficiary and the customer agrees to reimburse the issuer for the amount paid out under the credit, plus a commission.[18] In submitting the draft,[19] the beneficiary must comply with the terms and conditions supplied by the customer in its contract with the issuer.[20] If the documents tendered by the seller (the beneficiary) comply, the issuer "must" pay;[21] no interference from the customer is allowed.[22] The letter of credit is thus an "engagement"[23] by the issuer to the beneficiary, on account of the customer, to support the customer's agreement to pay money under the customer-beneficiary contract.[24]

In general, letters of credit are used in one of two ways: either as a mechanism of payment,[25] or as a guaranty.[26] When used as a payment mechanism they are known as commercial (traditional) letters of credit.[27] When used as guarantees they are called standby letters of credit.[28]

The commercial letter of credit is used exclusively in the sale of

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18. The Code expressly provides for reimbursement unless otherwise agreed. U.C.C. § 5-114(3).

19. As defined in U.C.C. § 5-103 (1)(b), "[a] 'documentary draft' or a 'documentary demand for payment' is one in which honor is conditioned upon the presentation of a document or documents. 'Document' means any paper including document of title, security, invoice, certificate, notice of default and the like." *Id.* The term documentary draft was intended by the drafters to be construed in an extremely broad fashion. *See id.* § 5-103, Comment 2.

20. *See* Corporacion de Mercadeo Agricola v. Mellon Bank Int'l., 608 F.2d 43, 46-48 & n.1 (2d Cir. 1979); Ins. Co. of N.A. v. Heritage Bank, N.A., 595 F.2d 171, 173-174 (3rd Cir. 1979); Courtaulds N.A., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802, 805-06 (4th Cir. 1975); Int'l Leather Distribs. v. Chase Manhattan Bank, N.A. 464 F. Supp. 1197, 1201 & n.9 (S.D.N.Y.), *aff'd*, 607 F.2d 996 (2d Cir. 1979).

21. U.C.C. § 5-114(1); *e.g.*, Pringle-Associated Mtge. Corp. v. Southern Nat'l Bank, 571 F.2d 871, 875 (5th Cir. 1978); Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d 1077, app. A at 1081 (6th Cir. 1977) (per curiam) (adopting memorandum decision of lower court).

22. U.C.C. § 5-114, Comment 1. "The duty of the issuer to honor where there is factual compliance with the terms of the credit is . . . independent of any instructions from its customer once the credit has been issued and received by the beneficiary." *Id.* This rule may not be varied by contractual agreement. *Id.* § 5-114(1), Comment 1.

23. U.C.C. § 5-103(1)(a); *see* Baker v. Nat'l Blvd. Bank, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975).

24. *See* Pringle-Associated Mtge. Corp. v. Southern Nat'l Bank, 571 F.2d at 874 (5th Cir. 1978); Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d at 464-65 (2d Cir. 1970); West Virginia Hous. Dev. Fund v. Skroka, 415 F. Supp. 1107-12 (W.D. Pa. 1976).

25. *See infra* notes 29-31 and accompanying text.

26. *See infra* notes 32-33 and accompanying text.

27. Arnold & Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C. L.J. 272, 277 (1978).

28. *Id.* at 278.

goods.[29] In the typical commercial credit situation, a buyer (the customer) who has entered into a contract for the purchase of goods makes arrangements with his bank (the issuer) for the issuance of a letter of credit in favor of his seller (the beneficiary).[30] By such a credit, the seller receives payment for the goods upon presentment to the bank of drafts and specified documents.[31]

The standby letter of credit, on the other hand, differs from the commercial letter of credit in that the issuer will pay the beneficiary a certain amount upon presentation of documentation stating that its customer has defaulted on the underlying contract.[32] For example, a developer (the customer) contracts with a construction company (the beneficiary) who demands assurance that it will be paid in full upon completion of the building and insists that the developer obtain from a bank (the issuer), a standby letter of credit that will make payment available in the event the developer should default.[33]

The most significant difference between commercial and standby letters of credit is in the nature of the obligation of the issuer. The commercial letter of credit requires the issuer to pay the beneficiary in the ordinary course of performance, while the standby letter of credit requires the issuer to pay the beneficiary only when there has been default by the customer.[34] Hence, the name "standby" indicates that the letter of credit is only an instrument of assurance.[35]

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29. *Id.* at 277.

30. A simple hypothetical will help to clarify the traditional letter of credit transaction. Suppose that a New York businessman wishes to purchase custom-built desks from a London merchant. The merchant agrees to build thirty desks for $75,000. The manufacture of the desks will take eight months. The seller refuses to sell on credit because he is unable to obtain a reliable credit history on the buyer. The seller is concerned that the buyer will breach the agreement and leave him with thirty custom desks for which there is no ready market. Conversely, the buyer refuses to pay in advance because he is reluctant to forgo eight months use of the purchase price, and he also is concerned with the solvency of the seller's small business. This is where the commercial letter of credit comes into play. The New York businessman will have his bank issue a letter of credit in favor of the London merchant. The merchant will receive payment for the desks upon presentment to the New York bank of specified documents.

31. B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS 9, 33 & n.54 (1966).

32. *See* Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 581-85, 609-13 (1979).

33. Note, *Letters of Credit: Injunction As A Remedy For Fraud In U.C.C. Section 5-114*, 63 MINN. L. REV. 487, 494 (1979).

34. *See* Del Duca, *Pitfalls of "Boiler-Plating" Letters of Credit*, 13 U.C.C. L.J. 3 (1980).

35. It is not uncommon for buyer and seller to demand that a letter of credit be issued in standby transactions. This insures the performance of both parties.

III. COMMERCIAL PRINCIPLES—THE RULE OF INDEPENDENT CONTRACTS

The commercial principles governing the documentary[36] letter of credit are based on the premise that "banks deal in documents, not in merchandise."[37] From this, the courts have fashioned what has been termed the *independent contracts rule,*[38] which states that an issuer's obligation under its letter of credit is a commitment to pay solely in accordance with the terms of credit, *independent* of any underlying contract between the parties.[39] The issuer is under a legal duty to honor demands for payment that comply with the terms of the credit agreement, without reference to the beneficiary's performance of the underlying contract.[40] As codified in the Uniform Commercial Code, the issuer's obligation to its customer is to "examine documents with care so as to ascertain that on their face they appear to comply with the terms of the credit."[41] If the documents comply, then the payment must be honored "regardless of whether the goods or documents conform to the underlying contract."[42]

The letter of credit offers a degree of certainty for which parties to a complex transaction can bargain - certainty without which the parties may not be able to transact business at all.[43] The letter of credit is,

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36. The documents required are set out by the letter of credit and may vary. The Code defines "document as "any paper including document of title, security, invoice, certificate, notice of default and the like." U.C.C. § 5-103(1)(b). Other documents that might be required include commercial invoices, bills of lading, insurance policies, weighing certificates, certificates of quality, and customs clearance receipts. Comment, *Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions,* 4 CUM.-SAM. L. REV. 134, 143 (1973).

A "documentary" letter of credit requires the beneficiary to tender special papers before receiving payment. It provides maximum protection to the customer because the beneficiary must present all documents listed before he can draw against the letter. A "clean" letter of credit is used less frequently and requires only the drawing of a draft without any documents. *See* Verkuil, *Bank Solvency and Guaranty Letters of Credit,* 25 STAN. L. REV. 716, 718-19 (1973).

37. H. HARFIELD, *supra* note 4, at 71. *See, e.g.,* Itek Corp. v. First Nat. Bank of Boston, 730 F.2d 19, 24 (1st Cir. 1984); Rockwell Intern. Systems Inc. v. Citibank, N.A., 719 F.2d 583, 589 (2d Cir. 1983); Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 462 (2d Cir. 1970).

38. *See, e.g.,* Itek Corp. v. First Nat'l Bank of Boston, 730 F.2d at 24; *Venizelos,* 425 F.2d at 464-65; Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 722, 31 N.Y.S. 2d 631, 633-34 (Sup. Ct. 1940); Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 357, 336 A.2d 316, 323 (1975).

39. *See* cases cited in note 38 *supra. See also* H. HARFIELD, *supra* note 4, at 31-32.

40. *See* HARFIELD, *supra* note 4 at 180-84.

41. U.C.C. § 5-109(2).

42. *Id.* at § 5-114(1).

43. *See generally* KOZOLCHYK, *supra* note 31, at 11-12.

in effect, an allocation of risk between the customer and the beneficiary.[44] By requiring use of a letter of credit, the beneficiary may greatly reduce his risk of not being paid, however, certainty of payment for the beneficiary is risk of loss for the customer.[45] Since the rule of independent contracts requires the issuer to honor the drafts of the beneficiary despite defective performance of the underlying contract, the customer will be without a remedy if, for some reason, he is unable to make himself whole by suit on the contract.[46]

The rule of independent contracts produces desirable commercial results in most cases, as the customer is willing to expose himself to a risk of loss for the eventual commerical gain he may effect in a successful transaction. The rule produces questionable results, however, in the recurring situation where the underlying transaction is tainted by the beneficiary's fraud.[47] In cases of beneficiary fraud in which an action by the customer on the underlying contract would be ineffectual,[48] the rule of independent contracts would operate to unjustly enrich an unscrupulous beneficiary.

Faced with the harsh results that the rule of independent contracts could produce in these kinds of cases, some courts have concluded that the rule should not protect a fraudulent beneficiary.[49] Ju-

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44. *See Harfield, supra* note 2, at 257-58.

45. The degree of risk to the customer, like the degree of certainty to the beneficiary, is a matter of bargaining between the parties. If the letter of credit requires the beneficiary to present extensive documentation evidencing the performance of his obligations when presenting drafts for payment, the customer exposes himself to relatively little risk in entering the letter of credit agreement. The less evidence required, the greater risk undertaken. Justice, *Letters of Credit; Expectations and Frustrations* (pt. 1), 94 BANKING L.J. 424, 429-30 (1977).

46. In most international transactions, an action on the contract is a difficult undertaking because it must usually be litigated in the beneficiary's country. Engaging in litigation in other countries may be prohibitively expensive. *See* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973).

47. *See, e.g.*, Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. at 720-23, 31 N.Y.S. 2d at 632-35 (1941).

48. A customer's legal remedy for breach of the underlying contract may be ineffectual for several reasons, but the most common is the impending insolvency of either the customer or the beneficiary. The nearly insolvent customer may be faced with bankruptcy if he has to reimburse the issuer without receiving the anticipated benefits of the underlying contract. *See, e.g.*, Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973); NMC Enters., Inc. v. Columbia Broadcasting Sys., Inc., 14 U.C.C. Rep. 1427, 1429 (N.Y. Sup. Ct. 1974). Of course, an action on the underlying contract may be fruitless if the beneficiary is insolvent at the time of payment or becomes insolvent after disposing of the proceeds of the credit. *See, e.g.*, Shaffer v. Brooklyn Park Garden Apartments, 250 N.W. 2d 172, 181-182 (Minn. 1977).

49. *See, e.g.*, Old Colony Trust Co. v. Lawyers' Title & Trust Co., 297 F. 152, 158 (2d Cir.), *cert. denied*, 265 U.S. 585 (1924); Banco Tornquist, S.A. v. Am. Bank & Trust Co.,

dicial efforts, however, to balance the commercial utility of letters of credit against the desire to prevent the unjust enrichment of a defrauding beneficiary have been unsatisfactory as well as inconsistent. Case law prior to the adoption of the Uniform Commercial Code was unclear.[50] Section 5-114 of the Code,[51] in attempting to resolve the inconsistencies in the common law, appears merely to have codified them.[52]

IV. The "Fraud in the Transaction" Exception to the Rule of Independent Contracts

(a) The *Sztejn* Case

In the context of an ordinary breach of the underlying contract by the beneficiary, the rule of independent contracts is supportable on the ground that the customer has accepted the risk that payment may be made despite some defects in the beneficiary's performance.[53] If the rule were not observed and payment were not made, the parties' expectations and allocations of risk would be upset. Beneficiaries would soon cease to view letters of credit as means of rapid, guaranteed payment, and their commercial utility would be lost.[54]

As the degree of the beneficiary's breach increases to the point of "fraud," however, the rule of independent contracts produces inequitable results. Thus, a number of pre-Code cases recognized that there should be an exception to the independent contract rule in the case of beneficiary "fraud."[55] These courts held that an issuer could be enjoined from honoring a credit, even though the beneficiary had presented documents that technically conformed to its terms, when allowing honor would defraud the customer.[56]

The leading pre-Code case on the issue of whether an injunction[57]

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71 Misc. 2d 874, 875, 337 N.Y.S.2d 489, 490 (Sup. Ct. 1972); Kingdom of Sweden v. N.Y. Trust Co., 197 Misc. 431, 441-42, 96 N.Y.S.2d 779, 790 (Sup. Ct. 1949); Asbury Park & Ocean Grove Bank v. Nat'l City Bank, 35 N.Y.S.2d 985, 988-89 (Sup. Ct. 1942); *aff'd mem.*, 268 A.D. 984, 52 N.Y.S.2d 583 (1944); *Sztejn*, 177 Misc. at 722, 31 N.Y.S. 2d at 634-35; Higgins v. Steinhardter, 106 Misc. 168, 169, 175 N.Y.S. 279, 280 (Sup. Ct. 1919).

50. *See infra* notes 57-70 and accompanying text.

51. U.C.C. § 5-114.

52. *See infra* notes 90-99, 116-157 and accompanying text.

53. *See* Harfield, *supra* note 2, at 257-58.

54. *See, e.g., Sztejn*, 177 Misc. at 721, N.Y.S. 2d at 633; *Intraworld*, 461 Pa., 357-59, 336 A.2d at 323 (1975).

55. *See supra* note 49 and cases cited therein.

56. *Id.*

57. Injunctive relief is usually sought in letter of credit cases. *See* Harfield, *supra* note 2, at 260.

against a letter of credit was permissible was *Sztejn v. J. Henry Schroder Banking Corp.*[58] In *Sztejn*, the plaintiff had contracted with Transea Trader, Ltd., of Lucknow, India, to purchase a quantity of bristles. In order to pay for the bristles, *Sztejn* caused his bank to issue an irrevocable[59] commercial letter of credit to Transea providing for payment upon presentation of a draft, invoice and bill of lading made out to the bank's order.[60]

After shipping fifty crates of material, Transea presented the appropriate documents to the bank.[61] Before the bank paid the draft, however, Sztejn filed suit in New York State Supreme Court to declare the letter of credit and draft void, and to enjoin payment of the draft.[62] Sztejn alleged that Transea had filled the fifty crates with "cowhair, other worthless material and rubbish."[63] Transea moved the court to dismiss the complaint for failure to state a cause of action.

The question presented to the court was whether Sztejn had the right to intervene between the payor bank and the beneficiary (Transea). Moreover, the court was concerned as to whether or not there should be a "mechanical application of the doctrine, that, in letter of credit transactions, the criterion is form not ultimate truth."[64] The New York State Supreme Court found the independence of the letter of credit from the underlying contract of sale to be "well-established", articulating it as follows:

> [A] letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees

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58. 177 Misc. 719, 31 N.Y.S. 2d 631 (Sup. Ct. 1941). Although this case was not decided by New York's highest court, it is followed by courts throughout this country as well as abroad. *See, e.g.*, Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 359-60, 336 A.2d 316, 325 (1975); Edward Owen Eng'r Ltd. v. Barclays Bank, [1977] 3 W.L.R. 764, 771. The latter case was decided by the Court of Appeal of England and Wales. *See also* KOZOLCHYK, *Legal Aspects of Letters of Credit and Related Secured Transactions*, 11 LAW. AM. 265, 281 (1979).

59. An "irrevocable" letter of credit is one in which the issuing bank's obligation cannot be cancelled or altered unilaterally. The "revocable" credit is one in which the bank's obligation to pay may be modified or cancelled at any time, without notice to the beneficiary. Obviously, the beneficiary's certainty of enforcing the bank's promise in the case of a "revocable" credit is virtually nonexistent until the moment of actual payment by the bank. *See* H. HARTFIELD, *supra* note 4, at 40-42; KOZOLCHYK, *supra* note 31, at 19-21. Because of its limited appeal to risk-averse beneficiaries, the "revocable" letter of credit is very rarely, if ever, used in modern commercial transactions. *See* H. HARFIELD, *supra* note 4, at 41.

60. *Sztejn*, 177 Misc. at 720, 31 N.Y.S. 2d at 633.

61. *Id.*

62. *Id.*

63. *Id.*

64. *See* H. HARFIELD, *supra* note 15, at 82.

> to pay upon presentation of documents, not goods. The rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade.[65]

However, the court decided that the independence principle should yield if performance on the underlying contract is so inadequate that it cannot be characterized as a "mere breach of warranty regarding the quality of the merchandise."[66] Under these circumstances, the court must assume:

> that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where 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 the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.[67]

Enjoining payment of the draft in such situations would protect the interests of the issuing bank as well as those of its customer. "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."[68] Under the circumstances the court held that the customer (Sztejn) was entitled to enjoin the bank from making payment under these circumstances because this controversy involved not mere breach of warranty but an allegation of *intentional* failure to ship the goods.[69]

The *Sztejn* case thus appeared to carve out an exception to the rule of independent contracts, for cases in which the underlying transaction was tainted by beneficiary "fraud". As later cases showed, however, the holding of *Sztejn* was less than clear.[70]

(b) The Uniform Commercial Code

The fraud in the transaction exception created in *Sztejn* has been codified in Section 5-114 of the Uniform Commercial Code.[71] This sec-

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65. *Sztejn*, 177 Misc. at 720, 31 N.Y.S.2d at 633.
66. *Id.* at 723, 31 N.Y.S.2d at 634.
67. *Id.*
68. *Id.* at 723, 31 N.Y.S.2d at 635.
69. *Id.* at 722-23, 31 N.Y.S.2d at 634-65 (emphasis added).
70. *See infra* notes 84-157 and accompanying text.
71. *See* United Bank Ltd. v. Cambridge Sporting Goods Corp., 41 N.Y.2d 254, 259, 360 N.E.2d 943, 948, 392 N.Y.S.2d 265, 270 (1976); *but cf.* H. HARFIELD, *supra* note 4, at 605.

tion reads, in pertinent part:

> (1) An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.
> (2) Unless otherwise agreed, when documents appear on their face to comply with the terms of credit but a required *document . . . 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 holder in due course. . . ; 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.[72]

Subsection (1) of Section 5-114 embodies the traditional rule of independent contracts which is central to the letter of credit concept and was reaffirmed by *Sztejn*. A letter of credit is issued and honored without regard to the quality of the beneficiary's performance of the underlying contract.[73]

Subsection (2) delineates the issuer's obligations upon the presentment of documents which appear on their face to conform to the terms of the credit but are forged or fradulent, or if there is "fraud in the transaction."[74] Under subsection (2)(a), if the presenter of the draft is the equivalent of a holder in due course, the general rule of independent contracts applies. Like *Sztejn*,[75] the issuer is obligated to honor the presentment, even if forged or fraudulent.[76] Under subsection (2)(b), if the presenter is anything but a holder in due course, the bank is not *obligated* to honor.[77] It *may* honor despite notification from the customer of fraud, forgery, or other defect not apparent on the face of

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72. U.C.C. § 5-114 (emphasis added).

73. *Id.* § 5-114(1). *See also* U.C.C. § 5-109(1) which provides as follows: "An issuer's obligation to its customer . . . does not include liability or responsibility (a) for performance of the underlying contract for sale or other transaction between the customer and the beneficiary. . . . "

74. U.C.C. § 5-114(2).

75. *Sztejn*, 177 Misc. at 723, 31 N.Y.S.2d at 635.

76. U.C.C. § 5-114(2)(a). Section 3-302(1) defines a holder in due course a one who takes an instrument for value, in good faith and without notice of any fault of the instrument. *Id.* § 3-302(1).

77. *See* Note, *supra* note 33, at 494.

the documents; the Official Comment makes it clear that the issuer in subsection (2)(b) situations may also choose not to honor, either of its own volition or when requested to do so by the customer.[78] If the subsection (2)(b) conditions exist, and the issuer refuses to dishonor the drafts as requested by the customer, the customer may seek recourse in a court. Section 5-114 may be said, therefore, to allow two sorts of dishonor under the letter of credit: elective dishonor where an issuer chooses to comply with a customer's request, and injunctive dishonor ordered by a court.[79]

For decades, legal analysts have tried to reconcile first *Sztejn* and, later Section 5-114(2) with the independence principle.[80] There would be no conflict if *Sztejn* and the Code permitted an injunction only for forged or fraudulent documents,[81] for every letter of credit implicitly requires the documents presented to be genuine.[82] But the phrase "fraud in the transaction" is obviously not so limited, and its meaning is not clarified anywhere in Article 5 or its Official Comments. This omission by the drafters of the Code has resulted in uncertainty as to the proper standard of fraud, and also as to the bounds of the "transaction" that can properly be examined in determining the existence of the fraud.[83]

i. *Fraud*

Under Section 5-114, fraud is the only exception to the concept of independent contracts and is the sole basis for an injunction against honoring a letter of credit.[84] In examining the issue of fraud, the first question one must ask is how fraud should be defined. As has already been mentioned, neither the Code nor its Official Comments define

78. U.C.C. § 5-114, Comment 2.

79. *See* Note, *supra* 33, at 494.

80. *See generally* H. HARFIELD, *supra* note 4; Note, *supra* note 33, at 501-08.

81. What distinguishes a "fraudulent document" from a "forged document" or "fraud in the transaction" is unclear. As an example of a "forged document" the drafters probably had in mind a bill of lading created out of whole cloth by the beneficiary instead of by a carrier. A bill of lading properly issued by a carrier but altered by the beneficiary would have been a "fraudulent document." *See* Mentschikoff, *Letters of Credit: The Need for Uniform Legislation*, 23 U. CHI. L. REV. 571, 613 (1956). Some pre-Code decisions seem to have used the term "fraudulent documents" when actually concerned with performance of the underlying contract represented in the documents. *See, e.g.*, Shaffer v. Brooklyn Park Garden Apartments, 311 Minn. 452, 250 N.W.2d 172 (1977); O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 250 S.E.2d 587 (1978).

82. *See Sztejn*, 177 Misc. at 721, 31 N.Y.S.2d at 634.

83. *See* Note, *supra* note 33, at 497.

84. U.C.C. § 5-114(2).

fraud. As a result, courts, when considering the term "fraud"[85] in the context of beneficiary malfeasance, are divided as to its degree. Little guidance on this question can be had from *Sztejn*. Due to its procedural posture, the case was decided on the most extreme facts. The defendant bank had moved to dismiss the complaint for failure to state a cause of action. The court, therefore, had to assume that the allegations of the plaintiff customer were true; that the beneficiary had intentionally engaged in a scheme to completely defraud the customer.[86]

Several courts have viewed the Code's failure to define fraud as implicitly permitting them broad discretion in applying equitable principles to the letter of credit cases.[87] These courts have been moving away from the strict standard of "egregious"[88] fraud by the seller (such as *Sztejn*, where the goods are totally nonconforming or nonexistent) to a more flexible "constructive" fraud standard.[89]

This constructive fraud concept was applied in *Dynamics Corp. of America v. Citizens & Southern Nat'l Bank*.[90] In that case, a standby letter of credit[91] was issued by Dynamics' bank in favor of India, in order to insure the delivery by Dynamics of certain defense related communications equipment to India.[92] The standby could be drawn upon by the presentation of a document signed by the Indian President stating that Dynamics had defaulted on its obligations under the contract.[93] When war broke out between India and Pakistan, the

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85. For a discussion of § 5-114 fraud, see Symons, *Letter of Credit: Fraud, Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338 (1980).

86. *Sztejn*, 177 Misc. at 721, 31 N.Y.S.2d at 633.

87. *See United Bank*, 41 N.Y.2d at 261, 360 N.E.2d at 949, 392 N.Y.S.2d at 271 (the court employed a broad standard in holding that a shipment of old, ripped, unpadded and mildewed gloves rather than new boxing gloves constitutes fraud in the transaction). *See also Dynamics*, 356 F. Supp. at 998 (intentional misrepresentation not necessary element of fraud).

88. Examples of some definitions of egregious fraud are: "outrageous conduct which shocks the conscience of the court," Symons, *supra* note 85, at 348; "flagrant violation of the beneficiary's obligation under the letter of credit," Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 602 (1978); and "situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served," *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 359, 336 A.2d 316, 324-25, 17 U.C.C. Rep. Serv. 191, 203 (1975) (for a discussion of *Intraworld* see *infra* notes 163-167 and accompanying text).

89. *See, e.g., Dynamics*, 356 F. Supp. at 998; *United Bank*, 41 N.Y.2d at 254, 392 N.Y.S.2d at 265; NMC Enters., Inc. v. Columbia Broadcasting Systems, Inc., 14 U.C.C. Rep. Serv. (Callaghan) 1427 (N.Y. Sup. Ct. 1974).

90. 356 F. Supp 991 (N.D. Ga. 1973).

91. *See supra* notes 31-32 and accompanying text.

92. *Dynamics*, 356 F. Supp. at 993.

93. *Id.* at 994.

United States placed an embargo on shipments to India, making further performance by Dynamics impossible.[94] As a result of the United States embargo, India claimed that there was no delivery (resulting in a breach by Dynamics) and presented the issuer with the documents required under the standby letter.[95] Dynamics, then bankrupt, claimed that India's demand for payment was fraudulent because the contract provided for delivery at Dynamics' plant, where the goods had been tendered.[96] In discussing the Section 5-114(2) standard of fraud, the court stated:

> [T]he law of fraud is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society . . . . [I]n a suit for equitable relief - such as this one - it is not necessary that the plaintiff establish all the elements of actionable fraud. Fraud has a broader meaning in equity [than at law] . . . and *intention to defraud or misrepresent is not a necessary element.*[97]

Applying this constructive fraud standard, the court viewed its task as "merely guaranteeing that India not be allowed to take unconscientious advantage of the situation and run off with plaintiff's money on a *pro forma* declaration which has absolutely no basis in fact,"[98] and it entered the injunction.

It is questionable whether fraud existed at all in the *Dynamics* case. Certainly the beneficary in *Dynamics* was not guilty of committing the grave and intentionally fraudulent acts which were committed by the beneficiary in *Sztejn.*

Dynamics establishes a broad, equitable standard of fraud which appears to sanction injunctive relief in cases where the beneficiary's behavior might be more properly characterized as defective performance. Widespread adoption of this rule could lead to the use of Section 5-114 as a device for litigating breach of contract,[99] quickly destroying the utility of the letter of credit altogether.

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94. *Id.*

95. *Id.* at 995.

96. *Id.* at 996.

97. *Id.* at 998 (citing S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192-95 (1963)) (emphasis added).

98. *Dynamics,* 356 F. Supp. at 999.

99. Presumably, everytime there was a breach of the underlying contract, the customer would attempt to enjoin the issuer from allowing the beneficiary to draw on the letter of credit.

ii. *"Fraud in the Transaction"*

Given the apparent difficulty in defining "fraud", it comes as no surprise that defining "fraud in the transaction" has also been problematic. The ambiguity arises from whether the phrase "fraud in the transaction" refers to fraud in the transaction as a whole, encompassing the underlying contract (the "broad" view),[100] or whether it refers strictly to fraud in the letter of credit contract between the issuer and beneficiary[101] (the "narrow" view).[102]

Again, the *Sztejn* case is not particularly helpful, since language in the opinion is susceptible to both the broad and narrow reading of "transaction". In one part of the *Sztejn* opinion, the court recognized that the doctrine of independent contracts "presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit."[103] Using this language as authority some courts have held that *Sztejn* stands only for the proposition that a document which falsifies the facts it purports to represent, in order to cover up a beneficiary's fraud, is a nonconforming document.[104]

Under this narrow interpretation of *Sztejn*, a court presented with a request for injunctive relief will only examine the conformity of the documents tendered under the letter of credit.[105] However, if the documents refer to the performance of the underlying contract, the court must then look beyond the letter to the beneficiary's actual performance to determine whether the documents are accurate.[106] By recalling the situation in *Sztejn* we can understand why this must be done; the

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100. This is referred to as the "broad" exception to the rule of independent contracts. American Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420, 424 (S.D.N.Y. 1979), *stay pending appeal denied*, No. 79-7527 (2d Cir. Aug. 14, 1979).

101. This is known as the "narrow" exception to the rule of independent contracts. *Id.*

102. *See* Harfield, *supra* note 88, at 605-06.

103. *Sztejn*, 177 Misc. at 721, 31 N.Y.S.2d at 634.

104. An illustration of this narrow reading is found in Merchants Corp. v. Chase Manhattan Bank, 5 U.C.C. Rep. 196 (N.Y. Sup. Ct. 1968). There the beneficiary presented documents under the letter of credit contract showing that goods were placed on board a ship in Korea not later than January 31, 1968. In fact, the goods were not loaded until February 13. Citing *Sztejn*, the court determined that the plaintiff customer was entitled to injunctive relief because his dispute with the beneficiary was "not as to warranty or breach of the contract between the buyer and seller but as to the terms of the letter of credit, the independent contract between the [beneficiary] and the issuer." *Id.* at 197. *See, e.g.*, Pringle-Associated Mtge. Corp. v. Southern Nat'l Bank, 571 F.2d at 874; Bossier Bank & Trust Co. v. Union Planters Nat'l Bank, 550 F.2d at 1077; Harfield, *supra* note 88, at 605; Verkuil, *supra* note 36, at 720 n. 23.

105. *See* Verkuil, *supra* note 36, at 722.

106. *See* KOZOLCHYK, *supra* note 31, at 464.

documents presented stated that fifty crates of bristles had been delivered to Sztejn.[107] The court had to scrutinize the beneficiary's performance of the underlying contract in order to determine whether or not fifty crates of bristles had actually been shipped.

In another part of the opinion, the *Sztejn* court recognized that the principle of independence "should not be extended to protect the unscrupulous seller,"[108] at least in cases of intentional and absolute nonperformance. This language seems to support the proposition that *Sztejn* was laying down a rather broad exception to the rule of independent contracts; that a court may examine the underlying contract and compare the beneficiary with his obligation thereunder, regardless of the form and contents of the documents presented under the credit.

These divergent views of *Sztejn* have provided the framework for differing interpretations of "fraud in the transaction" under Section 5-114(2)(b).[109]

The statutory language of Section 5-114[110] would seem to provide a broader exception to the rule of independent contracts than the narrow fraud in documents exception. If "fraud in the transaction" were limited to fraudulent documents Section 5-114 would be redundant, since subsection 5-114(2) already describes the steps to take if the documents are "forged or fraudulent."[111]

Under a broad interpretation of Section 5-114, courts and issuers have the liberty to look beyond the letter and directly to the underlying transaction upon a customer's allegations of fraud. They will have the right to scrutinize the beneficiary's performance of the underlying transaction and compare this with his obligations thereunder in order to determine whether his demand for payment constitutes fraud.

V. Adoption of the "Broad" View

There is a growning trend in letter of credit litigation toward adoption of the broad view of *Sztejn* and Section 5-114 when dealing with beneficiary fraud.[112] This tendency to adopt the "broad" view has

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107. *Sztejn*, 177 Misc. at 721, 31 N.Y.S. 2d at 633.

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

109. U.C.C. § 5-114.

110. *Id.*

111. *Id.* at § 5-114(2). *See* Edgewater Constr. Co. v. Percy Wilson Mortgage & Fin. Corp., 44 Ill. App. 3d 220, 233, 357 N.E.2d 1307, 1317-18 (1976).

112. These cases include Itek Corp. v. First Nat'l Bank of Boston, 730 F.2d 19 (1st Cir. 1984); Warner v. Central Trust Co., 715 F.2d 1121 (6th Cir. 1983); Rockell Int'l Sys. v. Citibank, 719 F.2d 583 (2nd Cir. 1983); Paccar Int'l v. Commercial Bank of Kuwait, 587 F. Supp. 783 (C.D. Cal. 1984); Universal Marine Ins. Co. v. Beacon Ins. Co., 581 F. Supp. 1131 (W.D.N.C. 1984).

begun to erode the commerical utility of the letter of credit.[113] Although the majority[114] of court decisions have adhered to the "narrow" view, there have been instances where courts have purported to follow the narrow view while actually looking beyond the letter of credit to the underlying transaction.[115]

In *Shaffer v. Brooklyn Park Garden Apartments*,[116] the beneficiary, attempting to collect under a standby letter of credit, presented certificates stating that the customer had failed to make payments on authorized loans. The court, in determining whether or not to grant injunctive relief, purported to adhere to the narrow view of *Sztejn* and Section 5-114 stating: "[W]here injunctive relief is sought, the fraud alleged must be in respect to the documents presented and not as to the underlying transaction."[117] The court, however, used the language, "loans which are payable," thereby incorporating the underlying loan contract into the letter of credit contract.[118] "The allegation of fraud made by the plaintiff [customer] is appropriate for injunctive relief," the court said, "since it concerns the certifications by [the beneficiary]."[119] Injunctive relief was granted because, according to the underlying loan contract, payment was conditioned on one of two events occurring, neither of which occurred. Therefore, the beneficiary was guilty of fraud.[120]

Another case where the narrow view was purportedly followed was *NMC Enters. Inc. v. Columbia Broadcasting System, Inc.*[121] In that case, the beneficiary shipped stereo receivers with power specifications that fell substantially below the amount warranted.[122] The beneficiary presented documents showing that the drafts being drawn by him were "due and owing." The court viewed the "due and owing" language as incorporating the underlying sales contract into the letter of credit contract. The court held:

If the [underlying] contract is tainted with fraud in its induce-

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113. *See, e.g.*, Harfield, *supra* note 88, at 605-606; Verkuil, *supra* note 36, at 720, n.23. *See also* note 157 and accompanying text.

114. *See* Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, 707 F.2d 680 (2d Cir. 1983); Roman Ceramics Corp. v. Peoples Nat'l Bank, 517 F. Supp. 526 (D. Pa. 1981.)

115. *See, e.g.*, Shaffer v. Brooklyn Park Garden Apartments, 250 N.W. 2d 172, 175 (Minn. 1977); NMC Enterprises, Inc. v. Columbia Broadcasting System, Inc., 14 U.C.C. Rep. 1427 (N.Y. Sup. Ct. 1974).

116. 250 N.W.2d 172 (Minn. 1977).

117. *Id.* at 180.

118. *See* Note, *supra* note 33, at 505.

119. *Shaffer*, 250 N.W.2d at 180.

120. *Id.*

121. 14 U.C.C. Rep. 1427 (N.Y. Sup. Ct. 1974).

122. *Id.* at 1428.

> ment, then any document or signed certificate which the letter of credit requires [the beneficiary] to submit, as a condition to [the issuer's] honoring the draft, that the amount covered by the draft 'is due and owing. . . ' is equally tainted.[123]

These cases are examples of the fact that more courts are looking at performance of the underlying transaction when called on to provide injunctive relief. It is unlikely that the beneficiaries in *Shaffer* and *NMC Enters.* contemplated that the underlying contract would be incorporated into the letter of credit contract when they submitted documents stating that the amount drawn under the credit was "payable" or "due and owing." It seems clear that these courts wanted to look at the whole transaction (*i.e.*, the letter of credit and underlying contract), and simply used this language as a means to get to the underlying transaction.

i. *The Iranian Letter of Credit Cases*

The most voluminous letter of credit litigation in recent years, occurred during the Iranian Revolution. The attack on the doctrine of independence continued in what have been termed the *Iranian Letter of Credit Cases.*[124] These cases arose because United States companies had billions of dollars in contracts outstanding with the Iranian government and its agencies.[125]

A typical scenario in the Iranian cases involved the following: first, the purchaser (the Iranian government) made an advance payment to the U.S. company with which it had contracted.[126] In return the Iranian purchasers would demand a guarantee of repayment, of the advance, as well as a performance guarantee.[127] These guarantees, made by Iranian banks, were payable to the Iranian purchasers upon the guarantor's receipt of the Iranian purchaser's statement that the U.S. company had defaulted.[128] The Iranian bank (the guarantor) required

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123. *Id.* at 1430.

124. For a thorough discussion of the Iranian cases, *see* Comment, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases,* 21 HARV. INT'L L.J. 189 (1980). A number of the claims for injunctive relief were brought in anticipation of demands under the letter of credit. *See, e.g.,* Stromberg Carlson Corp. v. Bank Melli Iran, 467 F. Supp. 530 (S.D.N.Y. 1979).

125. Rendell, *The Iranian Revolution Continues in the Courts,* EUROMONEY, June 1979, at 73.

126. *E.g.,* KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 12-13 (2d cir. 1979); *see* Rendell, *supra* note 125, at 73.

127. United Technologies Corp. v. Citibank, N.A., 469 F. Supp. 473, 475-77 (S.D.N.Y. 1979); Rendell, *supra* note 125, at 73.

128. *See, e.g., KMW Int'l,* 606 F. 2d at 12-13; *see* Rendell, *supra* note 125, at 73-75.

that the U.S. company have a United States bank issue a standby letter of credit with the Iranian bank as the beneficiary.[129] The standby letter was payable upon a declaration by the guaranteeing Iranian bank that it had been called upon to make payment to the Iranian purchaser under the guarantee.[130] The United States issuer-bank, as in all letter of credit situations,[131] would obtain an indemnification from its customer, the U.S. company.[132]

After the United States broke off diplomatic and economic ties with Iran,[133] the Iranian purchasers (the beneficiaries) pursued enforcement of the standby letters of credit, claiming default by the U.S. companies.[134] The U.S. companies (the customers) sought injunctive relief on the only available grounds, fraud.[135] Since 1979, U.S. companies have brought more than twenty separate actions to enjoin the honoring of standbys associated with Iranian government contracts.[136] The critical issue running through these cases was the independence of the letter of credit from the underlying contract.[137] Although the courts in a majority of the cases enforced the letter of credit if its terms were met,[138] there were instances in which the courts ignored the doctrine of independence.[139] These courts have enjoined the honoring of the letter because they looked to the performance of the underlying transaction.[140]

For example, in *Itek Corp. v. First Nat'l Bank of Boston*,[141] the First Circuit held that the beneficiary's fraud had "so vitiated the entire transaction that the legitimate purposes of independence of the issuer's obligation would no longer be served".[142] *Itek* involved a contract for the manufacture and sale of high-technology equipment to

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129. *Id.*

130. Rendell, *supra* note 125, at 73. The amount of the letter would correspond to the amount of the guarantee. *Id.*

131. *See supra* notes 11-35 and accompanying text.

132. Rendell, *supra* note 125, at 73.

133. N.Y. Times, Feb. 17, 1979, at 1, col. 3.

134. *See, e.g., KMW Int'l*, 606 F.2d at 13.

135. *See, e.g., KMW Int'l*, 606 F.2d 10; Harris Corp. v. Nat'l Iranian Radio & Television, 691 F.2d 1344.

136. *See* Comment, *supra* note 124, at 203.

137. *Id.*

138. *See supra* note 114 and cases cited therein.

139. *See, e.g.*, Harris Corp. v. Nat'l Iranian Radio and Television, 691 F. Supp. 1344 (11th Cir. 1982); Itek Corp. v. First Nat'l Bank of Boston, 511 F. Supp. 1341 (D. Mass. 1981), *vacated*, 704 F.2d 1 (1st Cir. 1983), *aff'd*, 730 F.2d 19 (1st Cir. 1984).

140. *See supra* note 115.

141. 730 F.2d 19 (1st Cir. 1984).

142. *Id.* at 25 (citations omitted).

Iran's Imperial Ministry of War, for $22.5 million.[143] Itek obtained a performance guarantee in favor of the War Ministry from an Iranian bank for $2.5 million, to be honored upon receipt of notice from the War Ministry that Itek had defaulted on the contract.[144] This guarantee was secured by the First National Bank of Boston (Itek's bank) in favor of the Iranian bank.[145] By 1979, when the Iranian government collapsed, Itek had billed the War Ministry for more than $20 million.[146] In April of 1979, the deterioriation of relations between the United States and Iran caused the U.S. government to suspend Itek's export license.[147] Itek later learned that the Iranian bank was demanding payment from the First National Bank under the terms of credit.[148] Itek sought an injunction against honor of the credit.[149]

In granting injunctive relief, the *Itek* court adopted the "broad" view and looked at the underlying transaction.[150] The court stated that the War Ministry had misrepresented the quality of Itek's performance.[151] It declared that it would be unfair to allow a beneficiary "to call a letter of credit under circumstances where the underlying contract plainly shows that he is not to do so."[152] The Court ultimately held that, under the circumstances, the Iranian bank's attempted call upon the letter amounted to fraud and permitted the injunction.[153]

In *Harris Corp. v. Nat'l Iranian Radio and Television,*[154] a case factually similar to *Itek*, the Eleventh Circuit also looked beyond the letter of credit in granting injunctive relief.[155] In looking at the underlying contract, the court held that the Iranian agency had misrepresented the quality of Harris's performance.[156]

Although the *Itek* and *Harris* court decisions represent the minority view, they do represent dangerous precedent as they sanction looking beyond the letter of credit (*i.e.*, use of the "broad" view).

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143. *Id.* at 20.
144. *Id.*
145. *Id.* at 20-21.
146. *Id.*
147. *Id.* at 21.
148. *Id.*
149. *Id.* at 21.
150. *Id.* at 24.
151. *Id.* at 25.
152. *Id.* at 24 (citing, *inter alia, Dynamics,* 356 F. Supp. at 991).
153. *Id.* at 28-40.
154. 691 F.2d 1344 (11th Cir. 1982).
155. The *Harris* court looked at the underlying contract and noted that the Iranian government agency had misrepresented the quality of Harris's performance. *Id.* at 1356. The court held that Harris would probably prevail on a "fraud in the transaction" claim and permitted the injunction. *Id.* at 1356-57.
156. *Id.* at 1356.

ii. *Implications of the "Broad" View*

Other recent letter of credit cases have also shown that courts are willing to look beyond the independence of the letter of credit to the underlying transaction.[157]

It is becoming apparent that adoption of the broad view of *Sztejn* and Section 5-114 has taken a toll on the commerical utility of letters of credit. The problem with the "broad" view is that by giving *all* customers the right to seek dishonor by alleging fraud, it encourages unscrupulous or overanxious customers to raise frivolous claims that would delay payment and force the beneficiary into litigation. Since the letter of credit involves a bargain between the customer and beneficiary, this unanticipated risk of delay or dishonor cannot be accounted for in the bargaining process. Thus, the letter of credit becomes a less attractive commercial device for prudent beneficiaries. This problem arises because a beneficiary is prevented from ensuring payment prior to litigation in those cases in which a customer rightfully or wrongfully alleges fraud.

VI. RECOMMENDATIONS FOR THE FUTURE

The equitable remedy of injunctive relief should remain as a remedy to prevent compounding an injury when intentional fraud is present. However, we have seen that some courts, when dealing with letters of credit, have probed the underlying transaction far beyond what the letter of credit contemplates.[158] In weighing the relative performance of the underlying contract and its warranties, courts have sometimes erroneously found fraud where the intent to deceive was lacking.[159] Furthermore, many courts have viewed "fraud in the transaction" too broadly, using it as an invitation to investigate the underlying transaction.[160] Such an expansive view reduces the likelihood that parties to complex transactions will use the letter of credit in their dealings. Thus, there exists a need to find ways to limit judicial intrusion into the letter of credit arrangement. It seems obvious that the only way to limit judicial scrutiny is to make *structural* changes in existing letter of credit law, thus eliminating the ambiguities that pres-

157. *See, e.g.*, Rockwell Int'l Systems, Inc. v. Citibank, N.A., 719 F.2d 583, 588-89 (2d Cir. 1983); Roman Ceramics Corp. v. Peoples National Bank, 714 F.2d 1207 (3d Cir. 1983); United City Merchants (Investments) Ltd. v. Royal Bank of Canada (H.L.(E.)) [1982] 2 W.L.R. 1039 (where court, citing *Sztejn*, looked to the underlying contract to find fraud).

158. *See supra* notes 116-23 and accompanying text.

159. *See supra* notes 90-99 and accompanying text.

160. *See supra* notes 116-57 and accompanying text.

ently invite intrusion.

i. *Modification of Section 5-114*

Much of the ambiguity that presently exists in letter of credit law stems from the numerous potential definitions of "fraud" and "fraud in the transaction" as used in Section 5-114.[161] There is a need to: (1) limit the scope of the term "fraud," and (2) to define exactly what is meant by "fraud in the transaction". "Fraud" should be clearly defined in the section and its accompanying Official Comments, and it should encompass only intentional fraud. This would eliminate "constructive fraud" as a basis for injunction.[162] Additionally, the ambiguity of "fraud in the transaction" can be eliminated by deleting the entire phrase from the section. This would compel courts to focus on the documents themselves rather than on the underlying contract in determining whether to grant injunctive relief.

ii. *Intraworld*

If changes cannot be made to the Uniform Commercial Code, it may be possible to look to judicial precedent for help. In *Intraworld Indus. Inc. v. Girard Trust Bank,*[163] a Pennsylvania court clearly defined a workable fraud standard which can be used when considering an injunction. In that case, a standby letter of credit was payable to the beneficiary upon the issuer's receipt of a statement made by the lessor-beneficiary prescribing that the lessee-customer had not paid the rent due on a resort hotel lease. When the issuing bank received this statement from the beneficiary, the lessee-customer, claiming that all the rent had been timely paid, sought to enjoin the bank from making payment.[164] In denying injunctive relief, the court stated:

> In light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit, we think that the circumstances which will justify an injunction against honor must be *narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of issuer's obligation would no longer be served.* A court of equity has the limited duty of guaranteeing that the beneficiary not be al-

161. U.C.C. § 5-114.
162. *See supra* notes 87-99 and accompanying text.
163. 461 Pa. 343, 336 A.2d 316 (1975).
164. *Id.* at 345-48, 336 A.2d at 318-21.

> lowed to take unconscientious advantage of the situation and run off with the plaintiff's [customer's] money . . . [upon documentation supplied to the issuer] which has absolutely no basis in fact.[165]

The *Intraworld* court realized that the independence of the issuer's obligation from the underlying transaction allows for commercial certainty and gives the letter of credit its utility.[166] The court set forth the well reasoned policy that it should only interfere in a letter of credit transaction (i.e. grant injunctive relief) when the beneficiary has acted in such a reprehensible manner in the underlying transaction that allowing him to receive payment under the letter would be unconscionable.[167]

This standard is helpful because it de-emphasizes abstract concepts of "fraud" and "transaction" that offer little guidance to courts confronted with close cases. Instead, it focuses attention on the purpose of the "independence of the issuer's obligation," which is to provide an assured mode of payment and thereby preserve the commercial utility of the letter of credit.

VII. CONCLUSION

The usefulness of the letter of credit in facilitating complex international and domestic transactions stems from the independence of the issuer's obligation to the beneficiary from the underlying transaction. The situations in which a court may prohibit the issuer from making payment under the letter should be clearly defined. Ambiguities must be removed from the law if the letter of credit is to retain viability.

Nadeem Faruqi

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165. *Id.* at 359, 336 A.2d at 324-25 (emphasis added) (quoting *Dynamics*, 356 F. Supp. at 999).

166. *Id.* at 357, 336 A.2d at 323.

167. *Id.* at 359, 336 A.2d at 324-25.