

**American Bar Association
Forum on the Construction Industry**

**Calls on Letters of Credit:
What Do We Do Now?**

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April 24-26, 2008
La Quinta Resort and Club—Palm Springs, California

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I. Introduction

With letters of credit the “promise and premise are ‘pay now, argue later.’”¹ Letters of credit are meant to provide risk allocation that is both certain and mechanical. Although performance bonds may be more prevalent in the construction industry, letters of credit offer owners and contractors advantages that performance bonds do not. Letters of credit, however, are unique financial instruments, and the parties to any transaction involving letters of credit must be aware of the distinct body of law that governs them. The purpose of this paper is to provide a basic understanding of letter of credit law, and insight into how letters of credit function in the construction context.

II. The Nature of Letters of Credit

A. Definition of Letter of Credit

A financial instrument, a letter of credit is essentially an issuing bank’s promise to pay a third party on behalf of a second party. Article 5 of the Uniform Commercial Code defines a letter of credit as a:

a definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant, or in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.²

Whether referred to as an “engagement” or “undertaking,” letters of credit operate as a promise to pay upon presentation of certain documents and provided the terms specified in the credit are satisfied. Letters of credit are not negotiable instruments, however, because they are not usually unconditional or payable on demand like a negotiable instrument, but rather they are most often dependent on presentment of a separate draft or demand for payment.³

B. Different Types of Letters of Credit Exist

There are different types of letters of credit. The most widely used types are “commercial” letters of credit, and “standby” letters of credit.

1. Commercial Letters of Credit

Commercial letters of credit are the older and more frequently utilized type of credit. Commercial credits frequently facilitate transactions for the sale of goods, particularly in international sales.

The typical commercial letter of credit is simply a payment mechanism used in international transactions. The credit is commonly used in a sale of goods transaction. The seller (beneficiary) agrees to ship goods to the buyer (customer) whose credit the seller does not trust. The seller wants to be sure that it will receive its money when it delivers the goods, while the buyer does not want to pay the seller in advance. So the buyer arranges to have a bank (issuer), whom the seller trusts, issue an irrevocable letter of credit to the seller. The bank will pay the seller only when the seller presents a draft and shipping documents, in addition to any other documents the buyer specified that indicate the seller has performed. The bank will then turn to the buyer for reimbursement ...⁴

Commercial letters of credit are essential and widespread tools in the facilitation of international trade. Under commercial letters of credit, the documentation that is presented shows that the beneficiary has performed and is entitled to payment from the bank that issued the letter of credit. Commercial letters of credit differ from standby letters of credit, which serve an entirely different purpose.

2. Standby Letters of Credit

Unlike commercial letters of credit, where the issuer bank anticipates making payment if the parties perform, the purpose of standby letters of credit is to guard against non-performance on an underlying agreement.⁵ Thus, issuing banks do not presume that they will pay under standby letters and credit, and about 0.03 percent of all standby credits end up as losses to the

bank.⁶ Ironically, though they serve a similar purpose, standby letters of credit are issued as security to sureties for many forms of surety bonds,⁷ and are also sometimes used in place of a performance bond.

The standby letter of credit has been called “akin to a guarantee, for the bank’s sole function is to act as surety for its customer’s failure to pay.”⁸ However, this is not correct, though some courts appear confused by the difference as well.⁹ At first glance, a standby letter of credit may appear identical to a surety or guarantee, because both devices are intended to answer for a default on an underlying agreement.¹⁰ However, the two devices are different and distinct from one another.¹¹ Surety bonds and guarantees are secondary obligations. A surety’s or guarantor’s obligation is contingent upon default of the underlying agreement.¹² Thus, a surety or guarantor examines the underlying agreement and the relevant facts and circumstances to verify that a default has in fact occurred.¹³ Until the default has been factually established, there is no obligation to pay.¹⁴

A letter of credit, on the other hand, is a primary obligation.¹⁵ The issuer’s obligation depends not upon the default itself, but upon the beneficiary’s presentation of conforming documents. Proof of the default, which is essential to the obligation of a surety or guarantor, is irrelevant to the obligation of a bank that has issued a letter of credit.¹⁶ Further, Article 5 of the UCC governs standby credits, but does not govern guaranties.¹⁷ Finally, banks are not authorized to issue guaranties or to act as a surety, but they are legally able to provide letters of credit.¹⁸

3. *Revocable vs. Irrevocable Letters of Credit*

Letters of credit may be either revocable or irrevocable. While the issuer of a revocable letter of credit may unilaterally amend or cancel the credit at any time prior to the beneficiary’s presentation, once an issuer has established an irrevocable letter of credit the issuer may not amend or cancel the credit without the beneficiary’s consent until the term set forth in the letter

of credit expires.¹⁹ Letters of credit are presumed to be irrevocable unless the letter of credit expressly permits revocability.²⁰

4. *Clean vs. Documentary*

Most standby letters of credit are “documentary.” A “documentary” letter of credit requires that certain documentation accompany presentment of a draft for payment, such as a certificate of default. A “clean” letter of credit is payable merely upon the presentation of a draft; no accompanying documents are necessary.²¹

III. Historical Uses for Letters of Credit

While negotiable instruments can be traced back to circa 3000 B.C., with at least one clay tablet promissory note existing from that time, an Egyptian cuneiform tablet is considered the earliest surviving letter of credit.²² Evidence supports the belief that letters of credit were used by Phoenician merchants and were issued by ancient Greek banks.²³ In these early times, merchants used letters of credit to avoid the costly and dangerous transport of gold and silver specie, and to facilitate foreign transactions involving commodities.²⁴ By the fourteenth century, letters of credit were prevalent among the merchant-bankers of Europe’s commercial centers.²⁵ The law that initially governed letters of credit was mercantile law, and was absorbed first into Europe’s civil law, and eventually into the common law.²⁶

The United States, inheriting the common law of England, also inherited mercantile law that was part of that common law, with the basic elements of a letter of credit already being well-established.²⁷ The Second Circuit Court of Appeals has described the initial utility of letters of credit as follows:

Originally devised to function in international trade, a letter of credit reduced the risk of nonpayment in cases where credit was extended to strangers in distant places. Interposing a known and solvent institution’s (usually a bank’s) credit for that of a foreign buyer in a sale of goods transaction accomplished this objective.²⁸

Early letters of credit were commercial letters of credit. “Standby” letters of credit came into use after World War II, and were widely used by the 1960s and 1970s.²⁹

IV. Legal Framework

A. Article 5 of the UCC

Article 5 of the Uniform Commercial Code governs letters of credit issued in the United States, and even outside the United States if the parties so designate. It is particularly effective because it provides a uniform statutory scheme. Article 5 was revised in 1995, and most states have adopted the revised version.³⁰

B. Uniform Customs and Practice for Documentary Credit (UCP)

There are alternatives to the UCC’s Article 5. The International Chamber of Commerce (ICC), representing a consensus of the world’s banking community, created the UCP, or Uniform Customs and Practices for Documentary Credit.³¹ The UCP is a compilation of internationally accepted banking customs and practices regarding letters of credit. The UCP is technically not law, but instead “de facto law” that courts use because it reflects existing industry practice.³² While typically the UCP must be expressly incorporated in the letter of credit in the United States for it to apply, some courts may choose to apply the UCP where there are gaps in the Uniform Commercial Code. For instance, New York and other states have enacted legislation referring to the UCP as controlling a letter of credit transaction, rather than Article 5, when the parties explicitly agree that the UCP will apply.³³ Contractors and owners engaged in international construction should be particularly aware of its possible application.

C. International Standby Practices (ISP)

The ISP,³⁴ also drafted in part by the International Chamber of Commerce, provides detailed rules to govern standby letters of credit. ISP 98 is particularly popular in international transactions. Similar to the UCP, whether the ISP applies also depends on whether it has been

specified in the credit documents. ISP rules are more stringent than some of the other regulations of the ICC, particularly regarding the extent of exactness required for presentation of documents for payment.

D. United Nations Commission on International Trade Law (UNCITRAL)

UNCITRAL came into effect in 2000 and applies primarily to international undertakings, including standby letters of credit.³⁵ Where the UN Convention is referenced in the letter of credit and the issuing bank is from a contracting country, the credit must expressly exclude UNCITRAL or else it will apply.³⁶

E. Case Law

Case law is an important source for interpreting factual circumstances involved in letters of credit, particularly because the Uniform Commercial Code, and the other applicable trade sources referenced above, do not contain sufficient detail to cover all situations. Further, it is essential to consult case law to determine how a jurisdiction construes the applicable code section or regulation.

V. Elements of a Letter of Credit

A. Parties

There are typically three parties to a letter of credit:

1. the issuer,
2. the applicant or customer, and
3. the beneficiary.

The “issuer” means a bank or other person that issues a letter of credit.³⁷

The applicant is the person or customer of the bank at whose request or for whose account a letter of credit is issued.³⁸

A beneficiary is the person who, under the terms of a letter of credit, is entitled to have a complying presentation honored.³⁹ Consideration is not required for issuance, amendment or transfer of a letter of credit.⁴⁰

B. Issuance

A letter of credit becomes legally enforceable upon issuance.⁴¹ Issuance occurs when the issuing bank transmits the letter of credit to the beneficiary.⁴² The credit may be issued in any form “that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties...”.⁴³ The instrument must be in writing and signed by the issuing bank.⁴⁴ It becomes effective when it is transmitted to the beneficiary.⁴⁵ Once an *irrevocable* letter of credit is issued, there can be no amendment or cancellation until the end of the term in the letter of credit unless the beneficiary consents.⁴⁶ Any ambiguity in a letter of credit must be resolved against the party drafting it.⁴⁷

1. Timing and Fees

Issuers often require applicants to pledge collateral to secure their promise to reimburse the issuer if the issuer has to honor the letter of credit. The customer may pledge acceptable securities accounts, as well as certificates of deposit from the bank as collateral for their letter of credit. Although much depends on the customer’s relationship with its bank, typically, the fees for a letter of credit are a small percentage of the letter of credit amount, as well as a processing fee or fees that are relatively nominal. Typically, letters of credit can be issued in short time periods as well, after completing a credit application and/or depositing sufficient collateral.⁴⁸

2. Drafting

The form of a letter of credit is important. A bank issued letter of credit falls within the scope of Article 5 of the UCC if it requires a documentary draft or documentary demand for

payment, or if it otherwise conspicuously states that it is a letter of credit or is conspicuously so entitled.⁴⁹ A letter of credit should indicate the following:

- that it is a letter of credit;
- that it is irrevocable;
- the amount of the credit;
- a place for presentation of documents;
- the exact identity of the beneficiary or beneficiaries;
- the documents required for payment;⁵⁰
- that payment will be made pursuant to a sight draft; and
- an expiration date, or automatic renewal.

Letters of credit typically have provisions relating to duration. For example: “It is a condition of this letter of credit that it shall be deemed automatically extended without amendment for one year from the present, or any future expiration date hereof, unless thirty days prior to any such date we shall notify you by registered letter that we elect not to consider this letter of credit renewed for any such additional period.”⁵¹ If there is no stated expiration date or other provision that determines its duration, a letter of credit expires one year after its stated date of issuance or, if none is stated, one year after the date on which it is issued. A letter of credit that states it is “perpetual,” expires five years after its stated date of issuance, or if none is stated, five years after the date on which it is issued.⁵²

In *National Surety Corporation v. Midland Bank*,⁵³ a bank refused to honor a beneficiary’s draw on a letter of credit stating that it was untimely, even though the letter of credit was supposed to be deemed automatically extended each year. The court held in favor of

the beneficiary, finding that –as to timing –the credit renewed each year, and the drafts presented within two and a half years of issuance were within a reasonable time period.

C. Presentment

Presentment means delivery of a document to an issuer for honor to obtain payment under the letter of credit. A draft is a written order by which the party creating it orders the issuing bank to make payment under the letter of credit.⁵⁴ Under letter of credit law, there are two types of drafts: sight and time. A sight draft is payable on presentment.⁵⁵ Time drafts, on the other hand, are payable a certain number of days after sight or after presentment for acceptance.⁵⁶ The purpose of a time draft is to give the issuing bank time to review attached documents to determine if they are in compliance with the terms of the letter of credit.⁵⁷

1. Statement Required

The standby letter of credit typically contains a condition requiring a statement upon presentment from the beneficiary that the customer has not performed, is in default, or that the beneficiary's liability has not been reduced.⁵⁸ If the letter of credit is specific as to the form that the statement should take, most jurisdictions require that it be strictly followed.⁵⁹

2. Honor or Dishonor

The bank is allowed a reasonable time to review the documents presented by the beneficiary for payment before making payment, but under the UCC not beyond the end of the seventh business day from the date of its receipt of the presenting documents.⁶⁰ In *Amwest Surety Insurance Co. v. Concord Bank*,⁶¹ the surety, who was the beneficiary, on a letter of credit posted as collateral for performance and payment bonds, sued the issuing bank for wrongful dishonor. The surety prevailed on summary judgment, and the Court based its decision in part on the failure of the bank to respond to the presentment of documents until more than 15 days later. Even then, the bank failed to provide all of the reasons for the dishonor, and then never

returned the presented documents.⁶² Upon becoming aware of a deficiency in the documents presented for payment, the bank must give notice to allow the beneficiary an opportunity to cure or remedy its presentment before the credit expires.⁶³ If the bank fails to provide timely notice of a defective presentment at a time when the beneficiary could have cured the defect before the expiration of the credit, it may be estopped or found to have waived any defense of failure to comply with the terms and conditions of the letter of credit.⁶⁴ In some jurisdictions and under some of the trade regulations, the issuing bank must provide clear and specific detail of the defect, or the notice of dishonor is not recognized.⁶⁵

As discussed in more detail below, the letter of credit creates an absolute, independent obligation, and payment must be made upon presentation of the proper documents, regardless of any dispute between the parties to the underlying agreement.⁶⁶ Except for certain circumstances also discussed below, the terms of the letter of credit control an issuer's liability, not external merits of an underlying agreement.⁶⁷ Ideally, the issuing bank's duty is ministerial in nature, confined to reviewing documents that are presented carefully against the terms of the letter of credit.⁶⁸

VI. Crucial Principles

Two crucial legal principles govern letters of credit in the United States: the independence principle and the strict compliance principle. These principles exhibit the fundamental policies and values that inform the letter of credit transaction.

A. The Independence Principle of Letters of Credit

There are generally three agreements that form the transaction in which a letter of credit is involved. First, there is the underlying business deal between the parties. Second, there is the letter of credit itself, a financial instrument between the issuer and the beneficiary, and third,

there is a reimbursement agreement between the applicant and the issuer so that the issuer is compensated for the money it pays to the beneficiary.⁶⁹

One of the fundamental principles governing letters of credit is that they are independent of any of the other related agreements, which includes independence from the business deal and from the reimbursement agreement.⁷⁰ Put another way, the obligations of an issuer to a beneficiary are unaffected by, or independent from, “the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.”⁷¹

This means that a breach of the underlying business agreement, by either party, has no effect on the duty of the issuing bank to honor a draw on the letter of credit when the terms and conditions of that letter of credit have been met.⁷² In *Eastland Bank v. Massbank for Savings*,⁷³ the court held that the issuer bank had wrongfully dishonored a draw on a letter of credit by looking to the underlying business transaction.⁷⁴ The letter of credit in that case supported an \$8 million construction loan for a condominium development project.⁷⁵ Although the issuer bank, Eastland, claimed that it had only intended the letter of credit to cover “the cost of finishing touches or punchlist items,” and not cure of a default that exceeded the face value of the letter of credit, the terms of the letter of credit allowed the beneficiary to make a draw if the applicant contractor defaulted on the project and if the amount sought by the beneficiary was necessary to cure the default.⁷⁶ Massbank, the beneficiary, made a proper presentation to Eastland, and the court, applying the independence principle, found Massbank was entitled to the face amount of the draft plus interest.⁷⁷

Also important is the independence of the letter of credit with regard to the reimbursement agreement. An issuer must comply with its obligations under the letter of credit without regard to whether it will be reimbursed, which may be particularly relevant when the applicant contractor becomes insolvent. Case law involving insolvent contractors naturally evolves from the misguided efforts of issuers to avoid payment when they know they will not be reimbursed. In *Eakin v. Continental Illinois National Bank and Trust Company of Chicago*,⁷⁸ the Seventh Circuit Court of Appeals addressed dishonor by an issuer when the contractor and the applicant surety were insolvent at the time of the draw. In holding the bank to the terms of the letter of credit, that court noted:

Letters of credit assure swift and reliable payment in commercial transactions. That promise was frustrated by [the issuer], which used flimsy pretexts to renege on a standby letter of credit supporting a construction contractor's bond.⁷⁹

The surety who had issued a surety bond supporting the contractor's performance on a reclamation project therefore was entitled to payment under the letter of credit.⁸⁰ Although the issuer had refused to honor the letter of credit to the point of incurring Rule 11 sanctions, the independence principle prevailed, and the issuer was forced to pay the beneficiary.⁸¹

1. No Duty to Investigate

Also part of the independence principle is the idea that the issuer, often a bank, has no duty to investigate the underlying business transaction before honoring a draw on the letter of credit.⁸² The issuer's function is ministerial in nature in that it must honor a conforming demand on a letter of credit and has absolutely no duty to investigate aspects of the underlying transaction.⁸³ Indeed, if the financial instrument is labeled as a letter of credit, but places a duty of investigation on the issuer, it may be outside the purview of Article 5 of the UCC, and may only be a letter of credit by name.⁸⁴

2. *Fraud or Forgery*

One marked but narrow exception to the independence principle applies in cases of fraud or forgery. When there is fraud in either the underlying business transaction, or in the letter of credit transaction itself (i.e., forgery),⁸⁵ the applicant may be able to seek injunctive relief preventing the issuer from paying the beneficiary.⁸⁶ When instances of fraud occur, and except in certain cases involving nominated persons, confirmers, holders in due course, or assignees, “the issuer, acting in good faith, may honor or dishonor the presentation.”⁸⁷ The fraud exception to the independence principle is primarily limited by two concepts: (1) the fraud must be “material” before a court will enjoin the issuer from paying the beneficiary,⁸⁸ and (2) the court must follow well-established equity principles before granting injunctive relief—for example, it must not order equitable relief where there is an adequate legal remedy.⁸⁹

In *Prairie State Bank v. Universal Bonding Insurance Co.*, the beneficiary was a surety on a construction project and was entitled to reimbursement if it paid any claims made against the contractor, Bauer Floor Covering.⁹⁰ However, when the surety attempted to draw on the letter of credit, it did so to pay claims incurred by Dwight Bauer Floor Company, a separate corporation with no relation to Bauer Floor Covering except in similarity of name.⁹¹ The beneficiary surety claimed that the bank had to honor the letter of credit, and the bank sought and received a declaratory judgment ruling that it had no obligation to honor the letter of credit on the basis of fraud.⁹²

In upholding this declaratory judgment in favor of the bank, the court noted:

The draw by Universal Bonding [the surety] had nothing to do with Bauer Floor Covering, Inc., which was the customer of the Bank and was a party to the letter of credit. Universal Bonding was attempting to obtain funds under false pretenses, which we consider to be fraudulent . . . The deceit of Universal Bonding in hiding the true facts from the Bank was fraud of “such an egregious nature as to vitiate the entire transaction.”⁹³

Prairie State Bank provides a good example of a case where the narrow fraud exception to the independence principle was recognized in favor of the issuer.

B. Strict Compliance

Strict compliance refers to the principle that any document presented by a beneficiary to an issuer must be in strict compliance with the terms and conditions of the letter of credit before the issuer will honor its obligations under the letter of credit.⁹⁴

1. Terms and Conditions

Strict compliance does not require “slavish conformity to the terms of the letter,” nor “oppressive perfectionism,” but under the UCC is a concept derived from standard practice.⁹⁵ The strict compliance standard as to the terms and conditions of the letter of credit “requires not only that the documents themselves appear on their face strictly to comply, but also that the other terms of the letter of credit such as those dealing with the time and place of presentation are strictly complied with.”⁹⁶

In one case involving the strict compliance standard, a court enjoined the issuer from honoring a letter of credit until it could be determined whether what the beneficiary had presented was a “commercial invoice” as required by the terms and conditions of the letter of credit.⁹⁷ The invoice issue arose after the applicant unilaterally cancelled the underlying business contract for construction of mini-storage units, causing the beneficiary contractor to send an invoice for its “benefit of the bargain damages.”⁹⁸ In discussing the strict compliance rule, the court noted:

If courts deviate from the rule of strict compliance and insist in certain undefined situations that banks made payments notwithstanding the fact that the beneficiary failed to comply with the terms stipulated in the letter of credit, the certainty that makes this device so attractive and useful may well be undermined, with the result that banks may become reluctant to assume the additional risks of litigation.⁹⁹

Another aspect of strict compliance requires the beneficiary to comply with the time and place requirements in the letter of credit.¹⁰⁰ Two cases with opposite outcomes illustrate this facet of the strict compliance standard.¹⁰¹ In the first case, the court held a beneficiary had acted within the terms and conditions of the letter of credit and therefore made a timely presentation.¹⁰² The dispute concerned the fact that the beneficiary presented a draft on the last day before the expiration of the letter of credit, after the lobby of the bank had officially closed, but while the drive-up window was still open.¹⁰³ The court noted:

The letter of credit made no reference that the sight draft must be presented before the lobby closed on June 26, 2002 . . . The letter of credit simply stated that the money was available by draft at “sight” and would be honored “if presented at this office in Shawnee, KS no later than June 26, 2002.”¹⁰⁴

In the second case, *Consolidated Aluminum Corp. v. Bank of Virginia*,¹⁰⁵ the court held that the beneficiary was not entitled to payment under a standby letter of credit when the beneficiary sent out the necessary documents to make a draw on the letter of credit, but due solely to delay of the mails, the documents did not reach the issuer before the date of expiration.¹⁰⁶ That court noted:

[T]he fundamental underlying rationale behind the rule of strict compliance with the expiration date of a letter of credit would appear to be applicable herein. That rationale is founded upon certainty and allocation of risk. The expiration date fixes with certainty the liability of the issuing bank. Before the expiration date, the bank has an absolute, unconditional obligation to pay provided that the beneficiary complies with the terms and conditions of the letter of credit. After that date, however, the bank has no obligation to pay.¹⁰⁷

These two cases illustrate that the strict compliance principle will protect a beneficiary who has presented a draft to the issuer that complies with the terms of the letter of credit, even if that presentation is made by knocking on a closed bank lobby door while only the drive-up window is open.¹⁰⁸ They also represent the flipside of the strict compliance principle, where a

beneficiary who does not make a presentation before the expiration date, even if that beneficiary was diligent and reasonable in relying on the postal service, will not be protected against the issuer's subsequent dishonor.¹⁰⁹

The strict compliance standard was at one time challenged by a looser "substantial compliance" standard.¹¹⁰ This standard is generally based on a misunderstanding of letter of credit law, and has now been widely rejected by courts and commentators alike.¹¹¹ Although issuers "cannot draw exact lines" concerning exactly what the strict compliance standard mandates,¹¹² their decisions must be informed by the good faith standard defined in Article 5 as "honesty in fact in the conduct or transaction concerned," a narrower standard of good faith than the standard applicable under Article 2.¹¹³

2. *Discrepancies*

An issuer must dishonor a presentation that does not strictly comply with the terms and conditions of a letter of credit.¹¹⁴ If there are discrepancies, the issuer must not honor the letter of credit,¹¹⁵ and must also give notice to the presenter of the discrepancies within "a reasonable time after presentation," that can not exceed seven business days after the receipt of the documents.¹¹⁶ An issuer must give this notice or it will be liable for wrongful dishonor.¹¹⁷ However, the issuer may refuse to honor a letter of credit on the basis of fraud, forgery, or presentation after the expiration of the letter of credit without providing notice to the presenting party.¹¹⁸

VII. Remedies and Defenses

A. Cause of Action by Beneficiary Against Bank for Wrongful Dishonor

Wrongful dishonor occurs when the issuer refuses the beneficiary's presentation, and does so improperly. It can also occur when the bank fails to honor the letter of credit or provide notice of discrepancies within the "reasonable time" set forth in U.C.C. § 5-108(b).¹¹⁹

1. *The Cause of Action*

Wrongful dishonor occurs when the issuer has not honored the letter of credit and has no meritorious defense to dishonoring.¹²⁰ In *Western Surety Co. v. Bank of Southern Oregon*,¹²¹ the issuer was liable for wrongful dishonor when it refused to pay the beneficiary, an insurer who had posted performance bonds on behalf of a construction company.¹²² The court granted a motion for summary judgment in the beneficiary's favor because it found that the beneficiary had made a proper presentation, and that the issuer, despite its allegations, could not raise a genuine issue of material fact as to the existence of fraud.¹²³

2. *Damages Available*

Both the beneficiary and the applicant may make claims for damages against an issuer who has wrongfully dishonored a letter of credit.¹²⁴ The beneficiary is entitled to “the amount that is the subject of the dishonor” plus “incidental but not consequential damages.”¹²⁵ The applicant may recover “damages resulting from the breach, including incidental but not consequential damages, less any amount saved by the breach.”¹²⁶ A party that is successful in proving wrongful dishonor by the issuer is also entitled to “interest on the amount owed” and is entitled to “reasonable attorneys fees.”¹²⁷

B. Defenses of the Bank to a Cause of Action by the Beneficiary for Wrongful Dishonor

Typically an issuer or bank facing a wrongful dishonor action can present one of the following defenses: expiration of the letter of credit, discrepancies between the beneficiary's presentation and the terms and conditions of the letter of credit, or fraud.

In a situation where an issuer asserts discrepancies as a defense, the beneficiary can argue that notice of the deficiencies in its presentation was inadequate. An entire trial can concern the singular issue of whether an issuer who claimed discrepancies between the beneficiary's

presentation and the terms and conditions of the letter of credit gave proper and timely notice to the beneficiary.¹²⁸ If a beneficiary makes a presentation close to the time of expiration of a letter of credit, the issuer will not be held to have acted in bad faith with respect to any dishonor based solely on the fact that the beneficiary was left with no time to cure his nonconforming presentation.¹²⁹

An issuer may also defend on the basis of fraud, but the common law cause of action for that tort further illustrates the limited application of such a defense:

To withstand summary judgment by establishing a claim for fraud, the Bank had to show that there was no genuine issue of material fact as to the following elements: (1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) his intent that it should be acted on by the person and in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) his reliance on its truth; (8) his right to rely thereon; and (9) his consequent and proximate injury.¹³⁰

The defenses of an issuer are limited, and the applicant or issuer may choose to waive defenses as to the draw, but in the absence of waiver, improper presentation by the beneficiary or fraud will protect the issuer against wrongful dishonor.

VIII. The Implications of Bankruptcy on a Letter of Credit

A chief benefit of being a beneficiary of a letter of credit is that the beneficiary's rights under a letter of credit are relatively unaffected if the customer files a petition in bankruptcy. This is because a letter of credit is not part of the bankrupt customer's estate, and other bankruptcy laws may affect the issuing bank, but not the beneficiary.

A. Letters of Credit Are Not Property of the Estate Under Bankruptcy Code 541

Under section 541 of the Bankruptcy Code, when a bankruptcy case is commenced an estate is created.¹³¹ The estate consists of "all legal and equitable interests of the debtor in

property...¹³² A beneficiary may draw on the proceeds of a letter of credit despite the fact that customer who procured the letter of credit filed for bankruptcy protection. “The letter of credit is an independent third party obligation, and the proceeds are not the debtor’s property even if, ...the letter of credit is secured by the debtor’s property.”¹³³ While the automatic stay does not provide the debtor with protection for draw down of letters of credit, it does insulate the debtor and its property. For instance, those banks that have issued letters of credit to back surety bonds cannot enforce their rights against the debtor’s collateral that secures the debtor’s reimbursement obligation without relief from the automatic stay.¹³⁴

For instance, consider the case of *Keene Corporation v. Acstar Insurance Co.*¹³⁵ There, the debtor has obtained several appeal bonds that the debtor previously secured by letters of credit to various different surety companies. While the automatic stay prevented the continuation of asbestos related litigation against the debtor, including the pending appeals, prevented the debtor’s banks from seizing the collateral backing the letters of credit, and prevented judgment creditors from satisfying their judgment against property of the estate, the automatic stay did not prevent or stay final judgment creditors from enforcing their judgments against the appeal bonds, nor did it stay or prevent the sureties from drawing the proceeds of the letters of credit in accordance with their terms.¹³⁶

B. The Preference Section is Also Unlikely to Apply

Section 547 (b) of the Bankruptcy Code provides for the trustee or a Chapter 11 debtor in possession to avoid any transfer of property to the debtor

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;

- (4) made –
 - (A) On or within 90 days before the date of the filing of the petition;
 - (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of each transfer was an insider; and
- (5) that enables such creditor to receive more than such creditor would receive if –
 - (A) the case were a case under Chapter 7 of the title;
 - (B) the transfer had not been made; and
 - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

An argument exists that honoring a letter of credit obtained by a debtor for the benefit of an unsecured creditor creates a preference when the bank pays it after the debtor's filing. *In re M.J. Sales & Distributing Company, Inc.*,¹³⁷ addressed this argument and found that “a bank honors a letter of credit and pays the beneficiary with its own funds, and not with assets belonging to the debtor who caused the letter of credit to be issued.” Accordingly, there is no preference because the payment depletes the assets of the issuing bank and not the debtor.¹³⁸ Thus, the court found there were no provisions of the bankruptcy code precluding payment to a beneficiary that holds the letter of credit, since the letter of credit and its proceeds represent property of the issuing bank, not the debtor.¹³⁹ There are, however, at least some instances where the beneficiary's draw on a letter of credit may be considered a preference. Thus, the specific facts of the situation and the timing of when the letters of credit are placed may play a significant role in such determination.¹⁴⁰

IX. Specific Applications

A. Challenges to Use of the Proceeds of a Letter of Credit

The “pay now, argue later”¹⁴¹ aspect of letters of credit becomes particularly relevant when a beneficiary benefits illegally, as through unjust enrichment, from the issuer’s obligatory payment under a letter of credit.¹⁴² Although the issuer is required to honor a conforming, non-fraudulent letter of credit despite any defenses the applicant may have against the beneficiary, the proceeds of the letter of credit are not immune from attack by the applicant.¹⁴³ After the letter of credit has been honored, courts may no longer apply the independence principle.¹⁴⁴ In a case where the issuer and the applicant may both attack the proceeds of the letter of credit, the applicant’s interest will most often prevail over the issuer’s interest, if any.¹⁴⁵

B. Monitoring Letters of Credit

The beneficiary, which is most often the owner in the construction context, must closely monitor the letter of credit. An issuer can rightfully refuse to honor an expired letter of credit. The beneficiary must also make the proper presentation in order to receive payment from the issuer. If these obligations are met, and absent fraud or forgery, the beneficiary should meet no resistance to payment by the issuer, and per the independence principle, the underlying transaction will not be relevant to the issuer’s payment of the beneficiary.¹⁴⁶

C. Used as a Replacement for Bonds

The independence principle is at the heart of the advantages that letters of credit have over performance or surety bonds in the construction context. Under a performance bond, the owner must convince the surety that default has occurred, and the surety must independently investigate this claim—often leaving the owner to fund the dispute, and the construction project in a state of disarray.¹⁴⁷ Further, the surety may oppose liability on the bond with a variety of defenses, and legal action on the part of the owner may only result in further cost and delay.¹⁴⁸

Significantly, the surety will generally withhold payment to the owner until the contractor's default is determined.¹⁴⁹

Contrast this situation with default that occurs and falls within the terms and conditions of a letter of credit. The issuer has no duty to investigate the alleged default, and must pay the owner absent fraud or forgery (or a non-complying presentation).¹⁵⁰ Even if the contractor alleges fraud or forgery, this may not prevent payment to the owner as the issuer may not wish to withhold payment.¹⁵¹ The contractor applicant would therefore have to seek injunctive relief. However, in the construction context, breach of contract actions would provide an adequate legal remedy in most instances, meaning injunctive relief would be unavailable to the contractor.¹⁵² Further, in contrast to the performance bond context, an owner beneficiary of a letter of credit is able to hold on to the money from the letter of credit while any litigation ensues to determine whether there was nonperformance or default by the contractor, shifting the burden of litigation costs, at least initially, to the contractor.¹⁵³

Under letters of credit, contractors receive the benefit of guaranteed payment to the beneficiary once the terms and conditions of the letter of credit are met. Owners receive the benefit of payment prior to any litigation concerning the underlying contract.

X. Conclusion

The growing importance of letters of credit in the construction industry must be accompanied by growing knowledge of the same. The distinction between letters of credit and other financial instruments or performance bonds is the independence principle, which makes the letter of credit standalone from any other agreement. In both the drafting of a letter of credit, and in any dispute involving a letter of credit, one must consider not only the independence principle, but also two guiding principles of letter of credit law—certainty and risk allocation. A beneficiary

and applicant seek the certainty of payment upon proper presentation of drafts to the issuer; the issuer seeks the certainty of not having to pay in instances of material fraud or improper presentation by the beneficiary. All parties seek the mechanical risk allocation that is embodied in Article 5 of the Uniform Commercial Code and embraced by judges and practitioners who understand modern mercantile law.

¹ *Eakin v. Continental Ill. Nat'l Bank and Trust Co. of Chicago*, 875 F.2d 114, 116 (7th Cir. 1989) (Easterbrook, J.).

² UCC § 5-102(a)(10) (revised 1995).

³ *See United Technologies Corp. v. Citibank*, 469 F. Supp. 473, 478 (S.D.N.Y. 1979).

⁴ 1 CORPORATE COUNSEL'S GUIDE TO LETTERS OF CREDIT, §1:2 (2007).

⁵ *Id.*

⁶ *Id.* at §1:92.

⁷ *United Bank of Denver National Assoc. v. Quadrangle Ltd.*, 596 P.2d 408 (1979) (supersedeas bond); *National Surety Corp. v. Midland Bank*, 551 F.2d 21 (3d Cir. 1977) ("release of libel" bond); *Travelers Indemnity Co. v. Flushing National Bank*, 396 N.Y.S.2d 754 (1977) (lis pendens release bond).

⁸ *New Jersey Bank v. Paladino*, 389 A.2d 454, 459 (N.J. 1978).

⁹ *See Ochoco Lumber Company v. Fibrex & Shipping Company Inc.*, 994 P.2d 793 (Or. 2000).

¹⁰ *Paladino*, 389 A.2d 454.

¹¹ *See* UCC § 5-103, cmt. 1.

¹² *Id.*

¹³ *See generally*, E. Gallagher, THE LAW OF SURETYSHIP (2d ed. 2000).

¹⁴ E.g., *Cates Construction, Inc. v. Talbot Partners*, 21 Cal.4th 28, 86 (Cal. Ct. App. 1999). In particular, as the Supreme Court of California stated:

A surety is "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor." . . . A surety bond is a "written instrument executed by the principal and surety in which the surety agrees to answer for the debt, default, or miscarriage of the principal." . . . In suretyship, the risk of loss remains with the principal, while the surety merely lends its credit so as to guarantee payment or performance in the event that the principal defaults. . . . In the absence of default, the surety has no obligation.

Id. at 38.

¹⁵ John F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credit*, Section 2.01 (A.S. Pratt ed., rev. ed. 2003).

¹⁶ *New York Life Ins. Co. v. Hartford Nat'l Bank, & Trust Co.*, 378 A.2d 562 (1977).

¹⁷ UCC §5-103, cmt. 1 (“this article does not apply to ... guarantees...”).

¹⁸ *United Bank of Denver National Assoc. v. Quadrangle, Ltd.*, 596 P.2d 408 (1979).

¹⁹ *See Dolan, supra* note 15, Section 2.10(1).

²⁰ UCC § 5-106(a).

²¹ J. White and R. Summers, *Handbook of the Law under the Uniform Commercial Code*, § 18-1 (1972).

²² Rufus James Trimble, *The Law Merchant and The Letter of Credit*, 61 HARV. L. REV. 981-84 (1948).

²³ *Id.* at 984.

²⁴ *Id.*

²⁵ *Id.* at 985.

²⁶ *Id.*

²⁷ Trimble, *supra* note 22, at 991-92.

²⁸ *Voest-Alpine International Corp. v. Chase Manhattan Bank*, 707 F.2d 680, 682 (2d Cir. 1983).

²⁹ Giao Xiang & Ross P. Buckley, *The Unique Jurisprudence of Letters of Credit: Its Origin And Sources*, 4 SAN DIEGO INT'L L.J. 91, 98 (2003).

³⁰ Check your respective jurisdiction; *see also id.* at 115-88.

³¹ Dolan, *supra* note 15, Section 3.05.

³² Giao Xiang & Ross P. Buckley, *supra* note 29, at 111.

³³ N.Y. U.C.C. LAW § 5-102(4); ALA. CODE § 7-5-102(4); ARIZ. REV. STAT. § 44-2702(d); *Marine Midland Grace Trust v. Banco del Paris SA*, 261 F. Supp. 884 (S.D.N.Y. 1966).

³⁴ Copies of the ISP and UCP rules can be obtained from the ICC through its website, www.iccwbo.org.

³⁵ Giau Xiang & Ross P. Buckley, *supra* note 29, at 98.

³⁶ *Id.*

³⁷ UCC § 5-102(a)(9).

³⁸ UCC § 5-102(a)(2).

³⁹ UCC § 5-102(a)(3).

⁴⁰ UCC § 5-105.

⁴¹ UCC § 5-106(a).

⁴² UCC § 5-106.

⁴³ UCC § 5-104.

⁴⁴ UCC § 5-104, UCC §5-102(a)(14).

⁴⁵ UCC § 5-106(a).

⁴⁶ UCC § 5-106(b).

⁴⁷ *East Girard*, 593 F.2d at 602 (citing *Bank of North Carolina, N.A. v. Rock Island Bank*, 570 F.2d 202, 207 (7th Cir. 1978)); *Bossier Bank & Trust v. Union Planters National Bank*, 550 F.2d 1077, 1082 (6th Cir. 1977).

⁴⁸ See www.citibank.com, <http://sterlingbank.com>, and <http://corp.bankofamerica.com>, for examples.

⁴⁹ UCC § 5-102(1)(a),(c).

⁵⁰ *Travelers Indemnity Co. v. Flushing Nat'l Bank*, 396 N.Y.S.2d 754 (N.Y. 1977).

⁵¹ *Nat'l Surety Corp. v. Midland Bank*, 551 F.2d 21 (3rd Cir. 1977).

⁵² UCC § 5-106(c) and (d).

⁵³ 551 F.2d 21 (3rd Cir. 1977).

⁵⁴ UCC § 3-104(a).

⁵⁵ BLACK'S LAW DICTIONARY (5th Ed. 1979).

⁵⁶ *Id.*

⁵⁷ See *Colorado Nat'l Bank of Denver v. Board of County Comm'rs of Routt County*, 634 P.2d 32 (1981) (confusingly referring to a 15 day sight draft).

⁵⁸ *Id.*

⁵⁹ See, e.g., UCC § 5-109; *Colorado Nat'l Bank of Denver*, 634 P.2d 32.

⁶⁰ UCC § 5-108(b).

⁶¹ *Amwest Surety Ins. Co. v. Concord Bank*, 248 F.Supp.2d 867, 871 (E.D. Mo. 2003).

⁶² *Id.* at 881.

⁶³ *North Valley Bank v. National Bank*, 437 F. Supp. 70 (N.D.Ill. 1977).

⁶⁴ *Barclay's Bank v. Mercantile Nat'l Bank*, 481 F.2d 1224 (5th Cir. 1973); *Exchange-Mutual Ins. Co. v. Commerce Union Bank*, 686 S.W.2d 913 (Tenn. 1984); see also, UCC § 5-108(c) and (d).

⁶⁵ *Amwest*, 248 F.Supp.2d at 867.

⁶⁶ *First Empire Bank v. Federal Deposit Insurance Corp.*, 572 F.2d 1361, 1366 (9th Cir. 1978).

⁶⁷ *East Girard*, 593 F.2d at 602.

⁶⁸ *American Coleman Co. v. Intrawest Bank of Southglenn*, 887 F.2d 1382, 1389 (10th Cir. 1989) (citing *Marino Industries Corp. v. Chase Manhattan Bank, N.A.*, 686 F.2d 112 (2nd Cir. 1982)).

⁶⁹ See Beat U. Steiner, *An Updated Primer on Letters of Credit*, 28 COLO. LAW. 5, 6-8 (1999).

⁷⁰ *Amwest*, 248 F. Supp. 2d at 875 (“The most fundamental principle of modern letter of credit law is that the three (3) contractual relationships giving rise to the letter of credit are completely independent of each other, and the rights and obligations of the parties to one are not affected by the breach or nonperformance of any of the others.”) (citations omitted).

⁷¹ U.C.C. art. 5 § 5-103; see also UCP 600 art. 4 (“A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit.”); ISP 98 Rule 1.07 (“An issuer’s obligations toward the beneficiary are not affected by the issuer’s rights and obligations toward the applicant under any applicable agreement, practice, or law.”); UCP 500 art. 3.

⁷² See *East Girard*, 593 F.2d at 598 (holding issuer wrongfully dishonored draw on letter of credit when beneficiaries presentation complied with the terms and conditions of the letter of credit).

⁷³ 767 F. Supp. 29 (D.R.I. 1991).

⁷⁴ *Id.* at 35.

⁷⁵ *Id.* at 31.

⁷⁶ *Id.* at 34-35.

⁷⁷ *Id.* at 35.

⁷⁸ 875 F.2d 114 (7th Cir. 1989).

⁷⁹ *Eakin*, 875 F.2d at 115.

⁸⁰ *Id.* at 118.

⁸¹ *Id.* at 116.

⁸² See U.C.C. § 5-108(f) (“An issuer is not responsible for: (1) the performance or nonperformance of the underlying contract, arrangement, or transaction. . . .”); see also UCP 600 art. 4 (“An issuing bank should discourage any attempt by the applicant to include, as an integral part of the credit, copies of the underlying contract, proforma invoice and the like.”); ISP 98 Rule 1.08 (“An issuer is not responsible for: (a) a performance or breach of the underlying transaction. . . .”); UCP 500 art. 3(b) (“A Beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank.”).

⁸³ David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds With Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT’L L. REV. 51, 79-80 (2005) (“The independence principle, in tandem with the strict compliance doctrine, is designed to assure that the issuer performs only a ministerial function. . . . The issuer is not obliged or even permitted to stray outside of the four corners of the presented documents.”); see *First Nat’l Bank of Council Bluffs v. Rosebud Housing Authority*, 291 N.W.2d 41, 45 (Iowa 1980) (“The bank’s brief provides no authority which holds that an issuing bank has a right, let alone a duty, to look to the underlying agreement between its customer and the beneficiary. On the contrary, the principle that the letter of credit is an independent promise as stated in § 554.5114(1) has been uniformly applied and enforced.”) (citations omitted).

⁸⁴ *Id.*; U.C.C. § 5-102 cmt. 6 provides in part:

[E]ven documents that are labeled “letter of credit” may not constitute letters of credit under the definition in § 5-102(a). When a document labeled a letter of credit requires the issuer to pay not upon the presentation of documents, but upon the determination of an extrinsic fact such as applicant’s failure to perform a construction contract, and where the condition appears on its face to be fundamental and would, if ignored, leave no obligation to the issuer under the document labeled letter of credit, the issuer’s undertaking is not a letter of credit.

Id.

⁸⁵ Controversy exists both in the case law and commentary over whether fraud in the underlying transaction protects the issuer. Some believe that only fraud or forgery relating to the presentation drafts or the letter of credit itself should allow the issuer to legally dishonor. For an article exploring this controversy and discussing the seminal case applying the fraud exception to the independence principle, see Henry Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L. 596 (1978).

⁸⁶ U.C.C. § 5-109(b) (“If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant...a court of competent jurisdiction may temporarily or permanently enjoin the issuer...”); This may even be the case under the UCP, where no specific provision on fraud exists. See *Prairie State Bank v. Universal Bonding Insurance Co.*, 953 P.2d 1047, 1051 (Kan. Ct. App. 1998) (“We have examined the UCP in this regard and, while it does not specifically disallow a defense of fraud in the transaction, it also does not specifically provide for it either. We consider the UCP to be silent on the subject, and in such cases the UCC would apply.”)

⁸⁷ *Id.* at § 5-109(a)(1)-(2).

⁸⁸ *Id.* at § 5-109(b) (“If an applicant claims that a required document is forged or *materially* fraudulent or that honor of the presentation would facilitate a *material fraud* by the beneficiary on the issuer or applicant”) (emphasis added).

⁸⁹ U.C.C. § 5-109(b)(3) (the court may only enjoin the issuer if “all of the conditions to entitle a person to the relief under the law of this State have been met”); see Barru, *supra* note 83, at 87-92 (discussing the materiality standard and the law governing injunctive relief in the context of fraud and letters of credit).

⁹⁰ 953 P.2d 1047, 1049 (Kan. Ct. App. 1998); *cf* *Western Surety Co. v. Bank of Southern Oregon*, 257 F.3d 933 (9th Cir. 2001) (finding that issuer wrongfully dishonored two letters of credit because no fraud was present – the issuer had argued that two letters of credit corresponded to two different construction projects and that only one of the projects was in default – but the court read the terms of the letters of credit and did not inquire into the underlying business deal).

⁹¹ *Prairie*, 953 P.2d at 1047.

⁹² *Id.*

⁹³ *Id.* at 1052-53.

⁹⁴ U.C.C. § 5-108(a). That section provides:

Except as otherwise provided in Section 5-109, an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply with the terms and conditions of the letter of credit. Except as otherwise provided in Section 5-113 and unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear to so comply.

Id.; UCP 600 art. 14-16; ISP 98 Rules 4.01-4.19; see *Southern Energy Homes, Inc. v. AmSouth Bank of Alabama*, 709 So.2d 1180, 1187 (Ala. 1998) (“To invoke the fraud exception in this case would require an inquiry into the underlying contract, further disrupting the important commercial functions of credit law. . . In this case, Southern Energy has an adequate remedy at law.”); UCP 500 art. 14.

⁹⁵ U.C.C. § 5-108 cmt. 1.

⁹⁶ *Id.*

⁹⁷ *Atlas Mini Storage, Inc. v. First Interstate Bank of Des Moines*, 426 N.W.2d 686, 689 (Iowa Ct. App. 1988).

⁹⁸ *Id.* at 687.

⁹⁹ *Id.* at 688 (quoting *First Nat. Bank, etc. v. Rosebud H. Authority*, 291 N.W.2d 41, 45 (Iowa 1980)).

¹⁰⁰ U.C.C. § 5-108 cmt. 1 (“[T]he section requires not only that the documents themselves appear on their face strictly to comply, but also that the other terms of the letter of credit such as those dealing with the time and place of presentation are strictly complied with.”); see UCP 600 art. 14(i); ISP 98 Rule 4.06.

¹⁰¹ *Carter Petroleum Prods., Inc. v. Brotherhood Bank & Trust Co.*, 97 P.3d 505 (Kan. Ct. App. 2004).

¹⁰² *Id.* at 509.

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 510.

¹⁰⁵ 544 F. Supp. 386 (D. Md. 1982).

¹⁰⁶ *Id.* at 402.

¹⁰⁷ *Id.* at 397.

¹⁰⁸ *Carter*, 97 P.3d at 508.

¹⁰⁹ *See also Tuthill v. Union Savings Bank*, 166 A.D.2d 702, 702-03 (N.Y. App. Div. 1990) (finding that beneficiary's presentation after the letter of credit expired meant the bank did not wrongfully dishonor by not paying the beneficiary).

¹¹⁰ *Id.*; *see Flagship Cruises Ltd. v. New England Merchants Nat. Bank*, 569 F.2d 699 (1st Cir. 1978); *Espanol de Credito v. State Street Bank and Trust Co.*, 385 F.2d 230 (1st Cir. 1967).

¹¹¹ *See Dolan, supra* note 15, Section 6.02 (“Departures from the strict discipline of letter of credit law are mistaken in adopting a rule that permits less than punctilious compliance by the beneficiary.”).

¹¹² Margaret L. Mose, *Letters of Credit and the Insolvent Applicant: A Recipe for Bad Faith Dishonor*, 57 ALA. L. REV. 31, 44 (2005).

¹¹³ U.C.C. § 5-102(7); *see also* U.C.C. § 5-102 cmt. 3 (“This narrower definition [of good faith] . . . is appropriate to the decision to honor or dishonor a presentation of documents specified in a letter of credit.”).

¹¹⁴ U.C.C. § 5-108(a); *see also* UCP 600 art. 16(a) (employing “may” dishonor); ISP 98 Rule 4.01(a); UCP 500 art. 14(b).

¹¹⁵ U.C.C. § 5-108(a). This is true unless the issuer agrees otherwise with the applicant or except as otherwise provided in § 5-113. *Id.*; *see also* UCP 600 art. 16(b); ISP 98 Rule 5.05.

¹¹⁶ U.C.C. § 5-108(b); *see also* UCP 600 art. 16(d) (providing notice must be made no later than close of the fifth banking day subsequent to day of presentation); ISP 98 Rule 5.01; *cf.* UCP 500 art. 14(d)(i) (providing notice must be made no later than close of the seventh banking day subsequent to date the documents were received).

¹¹⁷ U.C.C. § 5-108(c); *see also* UCP 600 art. 16(f); ISP 98 Rule 5.03; *cf.* UCP 500 art. 14(e).

¹¹⁸ U.C.C. § 5-108(d); *see also* ISP 98 Rule 5.05.

¹¹⁹ *See Amwest*, 248 F. Supp.2d at 878 (finding, where there was no fraud in the transaction, that the defendant bank had wrongfully dishonored by failing to give timely and adequate notice to the beneficiary of its reasons for dishonor).

¹²⁰ See *Western Surety Co. v. Bank of Southern Oregon*, 257 F.3d 933, 937 (9th Cir. 2001) (“Inasmuch as the evidence offered by the Bank, even if accepted as true, does not support a conclusion that Western engaged in fraud in presenting the draft on Letter No. 192, there is no dispute of material fact on the issue. Consequently, the district court properly granted summary judgment to Western.”).

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.* at 936.

¹²⁴ U.C.C. § 5-111(a)-(b).

¹²⁵ U.C.C. § 5-111(a).

¹²⁶ U.C.C. § 5-111(b).

¹²⁷ U.C.C. § 5-111(d)-(e).

¹²⁸ *Occidental Fire & Cas. Co. v. Continental Bank, N.A.*, 918 F.2d 1312, 1316 (7th Cir. 1990) (“Continental allegedly delayed too long before notifying Occidental of the nonconformity and failed to give adequate notice of the problem to the liquidator. The district court held a bench trial on this issue.”).

¹²⁹ See *id.* at 1317-18 (finding issuer was entitled to dishonor four separate nonconforming draw attempts by the beneficiaries of the letter of credit).

¹³⁰ *Western Surety Co.*, 257 F.3d at 936 (applying Oregon law).

¹³¹ 11 U.S.C. 541(a).

¹³² *Id.*

¹³³ *Keene Corporation v. Acstar Ins. Co.*, 162 B.R. 935 (S.D.N.Y. 1994) (citing *Willis v. Celotex Corp.*, 978 F.2d 146, 148 (4th Cir. 1992)); *In re Ocana*, 151 B.R. 670, 672 (S.D.N.Y. 1993)).

¹³⁴ *Id.* at 941 (1994) (citing *In re M.J. Sales & Distributing Company*, 25 B.R. 608, 615 (Bankr. S.D.N.Y. 1982)).

¹³⁵ *Id.*

¹³⁶ *Id.* at 949.

¹³⁷ 25 B.R. 608 (S.D. 1982).

¹³⁸ *Id.* at 614.

¹³⁹ *Id.* at 616; *see also*, *In re War Eagle Constr.*, 283 B.R. 193 (S.D. W.Va. 2002); *In re Duplitronics*, 183 B.R. 1010 (Bkrcty. N.D. Ill. 1995). *But see Payne v. Clarendon Nat'l Ins. Co. (In re Sunset Sales, Inc.)*, 220 B.R. 1005 (10th Cir. 1998).

¹⁴⁰ 25 B.R. at 616.

¹⁴¹ *See supra* note 1 and accompanying text.

¹⁴² Carter H. Klein, *Standby Letter of Credit Rules and Practices Misunderstood or Little Understood by Applicants and Beneficiaries*, 40 U.C.C. L.J. 2 Art. 2 (Fall 2007).

¹⁴³ One commentator notes:

[T]he applicant cannot enjoin a draw under a letter of credit even though it has a well-founded belief that the draw is excessive, that the beneficiary should mitigate its damages, or that the beneficiary is obtaining a windfall . . . the proceeds of the draw are not transmuted into something that the beneficiary is entitled to retain if the amount drawn constitutes unreasonable liquidated damages or unjust enrichment or exceeds statutory, regulatory, or public policy limitations.

¹⁴⁴ *See Dolan, supra* note 15, Section 8.05.

¹⁴⁵ *Id.*

¹⁴⁶ *See supra* notes 2-6 and accompanying text.

¹⁴⁷ *Barru, supra* note 83, at 107.

¹⁴⁸ *Id.*

¹⁴⁹ Leslie King O'Neal, *They're Back: Letters of Credit Provided in Lieu of Surety Bonds*, 13 CONSTRUCTION LAWYER 3, 3 (Jan. 1993).

¹⁵⁰ *See, supra* notes 82-93 and accompanying text.

¹⁵¹ In many cases, the issuer would be unwise to risk wrongful dishonor by making an independent determination as to whether there was fraud or forgery. *See Eastland Bank v. Massbank for Savings*, 767 F. Supp. 29, 35 (D. R.I. 1991) (finding that issuer bank's fraud defense failed and that issuer was liable for face value of letter of credit plus 12 % per annum interest from the time of the first wrongful dishonor).

¹⁵² See *Southern Energy Homes*, 709 So.2d at 1187 (Ala. 1998) (“Clearly, a dispute exists between Southern Energy and GBH based on the underlying contract. However, “[f]raud claims should not become surrogates for breach of contract claims.”).

¹⁵³ See *Rose Developments, Inc. v. Pearson Properties, Inc.*, 832 S.W.2d 286, 288 (Ark. Ct. App. 1992) (citing J. Dolan, *The Law of Letters of Credit*, at 1-18, 1-19 (2d ed. 1991)).