LETTERS OF CREDIT: HAVE WE FULLY RECOVERED FROM THREE INSOLVENCY SHOCKS?

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In the early part of the 17th century, Gerard Malynes wrote:

The Credit of Merchants [banks?] is so delicate and tender, that it must bee cared for as the apple of mans eye: Hence it doth proceed that Letters of Credit are had in such reputation, that the giver of them will bee well advised before hee doe make them . . . . ¹

It should also follow that counsel, judge, and legislator should each "bee well advised before hee doe make" a judgment concerning letters of credit.

As with the methods designed to effect and secure payment other than by delivery of legal tender, acceptability of letters of credit in the commercial world is as "delicate and tender" as Malynes considered a merchant's credit to be. Consequently, counsel in a letter of credit case may win a battle in a lower court before a judge who has not been "well advised." A statute enacted by a legislature may "misspeak" in the same way. The unfortunate secondary effects of the win or the statute on letter of credit acceptability may far outweigh the resulting single-client benefit or statutory benefit.

Three recent cases² illustrate different insolvency shocks that affect

¹ G. MALYNES, CONSUETUDO, VEL LEX MERCATORIA, OR THE ANCIENT LAW-MERCHANT 104 (1st ed. 1622).
² The three cases are:
the functioning of letters of credit. Each initially gave a severe jolt to
the acceptability of letters of credit, and the subsequent effect of these
cases has been immense. To add to the confusion, different parties are
governed by different insolvency systems. Insolvency of the issuing bank
is governed by one legal system, while insolvency of the beneficiary
and account party is usually governed by the Federal Bankruptcy
Code. Should either party be an insolvent insurance company, a third
set of insolvency rules comes into play. The rules in each insolvency
system may not adequately treat letters of credit.

(B) Philadelphia Gear Corp. v. F.D.I.C., 587 F. Supp. 294 (W.D. Okla. 1982),
aff'd in part, rev'd in part, 751 F.2d 1131 (10th Cir. 1984), rev'd, 476 U.S. 426

(C) In re Twist Cap, Inc., 1 Bankr. 284 (D. Fla. 1979) (insolvent account party).
For critical analysis of the Twist Cap case, see Baird, Standby Letters of Credit in
Bankruptcy, 49 U. CHI. L. REV. 130 (1982); Chaitman & Sovern, Enjoining Payment
on a Letter of Credit in Bankruptcy: A Tempest in Twist Cap, 38 BUS. LAW. 21
(1982); Hahn & Schwartz, Letters of Credit Under the Bankruptcy Code, 16 U.C.C.
L.J. 91 (1983); McLaughlin, Letters of Credit as Preferential Transfers in Bank-
ruptcy, 50 FORDHAM L. REV. 1033 (1982); see also Saunders, Preference Avoidance
and Letter of Credit Supported Debt: The Bank's Reimbursement Risk in its Cus-
tomer's Bankruptcy, 102 BANKING L.J. 240 (1985); Unscrewing Twistcap (Counsel's
Corner), 100 BANKING L.J. 636 (1983).

1 Banks are expressly excluded from the coverage of the Bankruptcy Code. 11
Insurance Corporation [hereinafter F.D.I.C.], which subsequently become insolvent,
are governed by equity receiverships in which the F.D.I.C. acts in a dual capacity as
1986). The Federal Deposit Insurance Corporation Act authorizes the F.D.I.C., as
insurer, to purchase the failed bank's assets from itself as receiver in order to facilitate
a purchase and assumption of the failed bank's assets and liabilities. 12 U.S.C. § 1823

A non-insured state bank is subject to liquidation under that state's banking code.
See, e.g., 4 N.Y. BANKING LAW §§ 605-633 (McKinney 1971 & Supp. 1987); 7 PA.
affect the insolvency rules governing national banks. See Jennings v. United States Fi-

Should the issuer of the letter of credit be a savings and loan association insured
by the F.S.L.I.C., the latter would act as receiver and insurer.

are subject to Chapters 7 and 11 of the Bankruptcy Code. 11 U.S.C. 103(a) (1982 &
of the business upon insolvency, while Chapter 11 deals with reorganization of the
business.

and “creditor(s),” defined at 11 U.S.C. § 101(9) (1982 & Supp. III 1986), are also
allowed to proceed under Chapters 7 and/or 11 pursuant to section 103. The vast bulk
of insolvent letter of credit account parties (buyers) and beneficiaries (sellers) generally
fall within these broad provisions.

5 Insurance companies are expressly excluded from liquidation under Chapter 7
As such, applicable state insurance law governs the insolvency of an insurance com-
pany. See, e.g., 42 CAL. INS. CODE §§ 1010-1062 (West 1972 & Supp. 1987); 40 PA.
CONS. STAT. ANN §§ 221.1-221.63 (Purdon Supp. 1986).
This article will first consider two fundamental principles of letter of credit law, the "independence principle" and the "strict compliance" rule. The question then arises as to whether these principles will be seriously affected by the insolvency rules, or whether they need modification to secure proper results when one or more of the three parties to a letter of credit transaction becomes insolvent. It will then examine the effect of the insolvency of each of the parties on letter of credit transactions — whether the insolvency be only of that party, or whether a different effect might be experienced where two of the three major actors become insolvent. Finally, it will discuss whether more satisfactory results could be obtained by revising the text or comments of Article 5 of the Uniform Commercial Code (U.C.C.) or of the relevant insolvency rules.

1. THE INDEPENDENCE PRINCIPLE

Familiar to those dealing in letters of credit is the prohibition against treating the entire "transaction" as one "deal." For letters of credit to be commercially acceptable as a means of payment, any analysis must proceed on the basis of the existence of at least three entirely independent contracts for almost all purposes. The typical transaction involves a contract between two or more parties calling for the payment of money on a specified occasion pursuant to a letter of credit. As between themselves, one party could be called the "recipient of money," and the other the "contractor to pay." The specified occasion for the money payment may be a shipment of goods, an arrival of goods, the performance of services, or the payment of liquidated or other damages.


Even the "may honor" exception under the Uniform Commercial Code [hereinafter U.C.C. or Code] U.C.C. § 5-114(2)(b)(1978), where the presenter is not a holder in due course, should support dishonor only in the clearest cases of non-entitlement. Roman Ceramics Corp. v. Peoples Nat'l Bank, 714 F.2d 1207 (3d Cir. 1983) (also see J. Adams dissenting). But as is shown infra text accompanying notes 10-15, there are a few other occasions where this independence is disregarded.
This is known as "the underlying contract."

The second contract is between the "contractor to pay," now rechristened the "account party," and the bank issuing the letter of credit or causing the letter of credit to be issued. It is black letter law that this contract is independent of the underlying contract and the letter of credit itself. This contract is called the "application for the credit." In it, the "account party" specifies which documents are to be required under the letter of credit, and agrees to reimburse the issuer for, or supply the issuer in advance with, funds used or to be used for payment under the letter of credit. The contract also may provide for collateral in order to assure the issuer of advance or subsequent reimbursement upon the issuer's payment to the beneficiary.

The letter of credit itself is the third agreement. This agreement is between the issuer and the recipient of money, now appearing as "the beneficiary." The letter of credit states that the issuer will pay a described amount. It also specifies — often as a condition to the obligation to pay — any documents that must accompany the demand to make the demand proper. Further, it stipulates whether payment or negotiation must occur before a specified date, called the "expiry date." After such a date, there having been no prior demand for payment, the issuer's liability ceases. If the expiry date is keyed to negotiation, then

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One effect of the independence principle is that the issuer can refuse to amend — even at the request of both the applicant and the beneficiary. See AMF Head Sports Wear, Inc. v. Ray Scott's All-American Sports Club, 448 F. Supp. 222 (D. Ariz. 1978); see also East Bank v. Dovenmuehle, Inc., 196 Colo. 422, 589 P.2d 1361 (1978)(letters of credit cannot be modified by custom or usage of trade but query the effect of U.C.C. § 1-205); New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co., 173 Conn. 492, 378 A.2d 562 (1977) (modification of underlying contract does not alter terms of the letter); Intraworld Indus. Inc. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316 (1975) (payment pursuant to a letter of credit may be enjoined only if the beneficiary has no bona fide claim to payment or the underlying documentation has no basis in fact).

8 The general rule is that both banks and courts enforce credit expiry dates strictly, as time is considered of the essence. See Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802, 807 (4th Cir. 1975); Bank of Am. Nat'l Trust & Sav. Ass'n v. Liberty Nat'l Bank & Trust Co., 116 F. Supp. 233, 243 (W.D. Okla. 1953), aff'd, 218 F.2d 831 (10th Cir. 1955); Easton Tire Co. v. Farmers & Merchants Bank, 642 S.W.2d 396, 400 (Mo. Ct. App. 1982); Anglo-South Am. Trust Co. v. Uhe, 261 N.Y. 150, 184 N.E. 741 (1933); W. Pat Crow Forgings, Inc. v. Moorings Aero Indus., Inc., 93 Misc. 2d 65, 403 N.Y.S.2d 399 (App. Term 1978) (oral extension of expiry date ineffective); Siderius, Inc. v. Wallace Co., 583 S.W.2d 852, 860 (Tex. Civ. App. 1979) (issuer is under no obligation to honor a draft presented after the expiry
the issuer's obligation does not cease until a further time period — the reasonable time for presentment⁹ — has expired.

Although the "independence principle," if stated too broadly, would treat the three contracts as if they had no connection with each other, it seems more accurate to say that almost all defenses to performance and almost all failures of consideration under any one contract do not automatically impair or suspend obligation of either of the other two. Nevertheless, a contractor to pay, for example, is interested in having the payment made under the letter of credit upon the proper tender of documents. The recipient of money wants to ensure certainty of payment upon proper tender. The issuer of commercial credit is interested in the quality of the goods, the subject of the underlying contract, because they often are part and parcel of the preferred security that induced the issuance of the letter.

Exceptions to the independence rule protect, in a very limited sense, the interests that cross over into the other independent contracts. These exceptions are the "fraud in the transaction" rule¹⁰ and the ille-

⁹ As Professor Dolan makes clear, "the time that honor occurs is a matter of negotiable instruments law, not letter-of-credit law." J. DOLAN, supra note 6, at ¶ 5.03[2][b]. These rules are contained in Article 3 of the U.C.C. See 5 W. HAWKLAND & L. HOLLAND, UNIFORM COMMERCIAL CODE SERIES § 3-502:01 (1986). U.C.C. § 3-503 (1)(e) provides that to fix the liability of any secondary party "presentment for acceptance or payment of any other instrument is due within a reasonable time after such party becomes liable thereon." Section 3-503 also states:

(3) Where any presentment is due on a day which is not a full business day for either the person making the presentment or the party to pay or accept, presentment is due on the next following day which is a full business day for both parties.

(4) Presentment to be sufficient must be made at a reasonable hour, and if at a bank during its banking day.

Id. Excused delay is covered by U.C.C. § 3-511, Waiver and Excuse. We presume that Professor Dolan would not include any states which allow extensions of time to pay stated in U.C.C. Article 3. This begs the question: if honor is governed by Article 3, should not actions constituting an extension of time to honor also be included?

¹⁰ The leading fraud case is Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). There, the beneficiary presented invoices describing the contract merchandise as "bristles" required by the credit. The account party, claiming that the beneficiary had instead shipped worthless horse-hair materials,
It is submitted that just as the rules pertaining to the
gality rule. It is submitted that just as the rules pertaining to the
alleged that the documents were fraudulent, and sued to enjoin payment of the credit. The court concluded that while the independence principle should be the rule, it does not extend "to protect the unscrupulous seller [who engages in an] . . . intentional fraud." Id. at 722, 31 N.Y.S.2d at 634; see J. Dolan, supra note 6, at ¶ 7.04[2]. For codification of the Sztejn rule, see U.C.C. § 5-114(2); see also Sztejning (Steining) the Letter of Credit: More Strings for the Bow (Counsel's Corner), 93 Banking L.J. 954 (1976).

Hence, the general rule has evolved to the point that, where there is evidence of fraud in the transaction, the issuer may, but is not obliged to, refuse to honor the demand for payment where in fact the presenter is not a holder in due course, nor a "due negotiatee" of a required document of title. U.C.C. § 5-114 official comment 2. See, e.g., Itek Corp. v. First Nat'l Bank of Boston, 730 F.2d 19 (1st Cir. 1984) (injunction obtained through showing of fraud and no alternative legal remedy); First Commercial Bank v. Gotham Originals, Inc., 64 N.Y.2d 287, 475 N.E.2d 1255, 486 N.Y.S.2d 715 (1985); Chiat/Day Inc., Advertising v. Kalimian, 105 A.D.2d 94, 483 N.Y.S.2d 235 (App. Div. 1984) (landlord not enjoined from drawing upon letter of credit purchased by tenant because lease was only breached in part, and monetary damages were an available remedy); see also J. Dolan, supra note 6, at ¶ 7.04[3]; Anderson, Uniform Commercial Code § 5-114:11 (3d ed. 1985); 6 W. Hawkland & L. Holland, Uniform Commercial Code Series § 5-114:05 (1986).

Although commonly called "the fraud in the transaction rule," the preamble in subsection (2) of U.C.C. § 5-114 refers to four situations: (i) Breach of a warranty of negotiation or transfer of a document of title or security; (ii) A forged required document; (iii) A fraudulent required document; or (iv) Fraud in the transaction. A full discussion of enjoining honor is beyond the scope of this paper. However, the House of Lords, while recognizing the doctrine of "fraud in the transaction," see, e.g., Discount Records Ltd. v. Barclays Bank Ltd., [1975] 1 W.L.R. 315 (Ch. 1974), has limited the rule to fraud committed or participated in by a beneficiary, and has ruled that no injunction could be issued where independent shipping brokers had, without the knowledge of the beneficiary, fraudulently backdated a shipping document to make it comply with the credit "on its face." United City Merchants (Investments), Ltd. v. Royal Bank of Canada, [1982] 2 W.L.R. 1039 (H.L.). Interestingly, there was no indication that the account party had participated in fraud. Id.


For a further discussion on enjoining honor of commercial or standby letters of credit when there is no fraud in the transaction, see Thorup, Injunctions Against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves?, 101 Banking L.J. 6 (1984).

Where the countries of both the account party (England) and the beneficiary (Peru) were parties to the Bretton Woods Agreement to recognize each others' currency control laws, a court in one country should not enforce the part of the transaction constituting a fraud on the currency control scheme of the other country. See Articles of Agreement of the International Monetary Fund (Bretton Woods Agreement), July 22, 1944, 60 Stat. 1401, T.I.A.S. No. 1501. Thus, where Peruvian buyers had induced British sellers to double the cost on their invoice and draft under the letter of credit (for which the foreign exchanges could be purchased legally) and deposit the excess to the buyer's credit in a bank in Miami, Florida (which could not legally be done directly by the buyers), recovery under the letter on the final drawing was reduced by one half. United Merchants (Investments), Ltd. v. Royal Bank of Canada, [1982] 2 W.L.R. 1039, 1051 (H.L.). No reduction, however, in the required payment was made in respect of the fraudulent increase in the prior drawing.
"real defenses" have not impaired the usefulness and acceptability of negotiable instruments, the rules of fraud in the transaction and illegality, if not unduly extended, will not impair either the usefulness or the acceptability of letters of credit. Further, just as the rules for the recovery of payments made have not had a totally adverse effect on the acceptability of negotiable instruments, the few rules permitting recovery of payments made under letters of credit will not destroy the usefulness of this payment-assuring device.

Thus, a complete failure of any of the three contracts affects the interests of one of the parties to each of the other two. To a limited extent, the law affords redress for this failure. Perhaps the independence principle correctly rests upon the premise that banks should not be required to decide the factual issues which are necessary to determine the existence of most defenses to an underlying contract. Nevertheless, if a bank is satisfied that a written settlement between the account party and the beneficiary is genuine, it should be able to


U.C.C. § 3-305(2) makes a holder in due course subject to the defenses of:

(a) infancy, to the extent that it is a defense to a simple contract; and
(b) such other incapacity, duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
(c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.

Id. A listing of proposed “real defenses” to a letter of credit would be quite different, and that is beyond the scope of this paper.

See F. BEUTEL, BEUTEL’S BRANNAN NEGOTIABLE INSTRUMENTS LAW 908-17 (8th ed. 1948) (the finality of payment rule for negotiable instruments was not followed in many states before the U.C.C.).

A complete failure of the beneficiary to perform (e.g., no timely presentation of documents) should result in the issuer’s release of collateral to the account party and give the account party rights against the beneficiary under the underlying contract. A wrongful failure of the issuer to pay leaves the account party with no goods, the beneficiary with no money, and the goods in a distant and perhaps unfamiliar market. If the account party wants the goods and has the funds, a direct payment would, in all probability, be accepted by the beneficiary despite the fact that the issuer’s wrongful dishonor constitutes a complete default by buyer under the underlying contract. A substantial increase in price, however, might change the beneficiary’s willingness to accept payment of the contract price.
terminate its obligations and release any collateral securing the account party's reimbursement obligation despite *Clement v. F.D.I.C.* and other case law to the contrary. Under any other rule the account party is deprived of the full effect of its settlement with the beneficiary. The decision in the *Clement* case, which reduced the beneficiary's recovery by the amount received from the account party, still deprived the account party of its full settlement. By recognizing the settlement, the court had already departed, as it should, from the full rigor of the independence principle. The court should have let the issuing bank honor the settlement if the bank had wanted to do so. Therefore, if a draw is made on the letter of credit after termination, the issuer should be protected in paying if it has not been satisfactorily informed of the cancel-

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16 2 U.C.C. Rep. Serv. 2d (Callaghan) 1017 (W.D. Okla. July 9, 1986). This case involved a standby letter of credit backing up notes issued for the purchase of oil and gas properties from the beneficiaries. The F.D.I.C. was sued for its anticipatory repudiation of a letter of credit issued by Penn Square Bank. The District Court refused to consider that a release between the account party and the beneficiary discharged the issuer. This was said to be required by the independence principle, as it would make "the issuer's liability on the credit derivative of the account party's liability on the underlying contract of sale." 2 U.C.C. Rep. Serv. 2d (Callaghan) at 1030. That statement is too broad for the facts of the case. A precise reading of the settlement would show that an underlying agreement no longer existed. However, afraid of permitting a double recovery, the court's seventh conclusion of law provided, "[t]he total amount of the plaintiffs' claims . . . must be reduced by the value plaintiffs have received through settlement with the account party." 2 U.C.C. Rep. Serv. 2d (Callaghan) at 1031. The court was looking at the underlying transaction, and this is permitted by U.C.C. § 5-115(1). The court's sixteenth and nineteenth findings cover the settlement agreement, which provided that plaintiff beneficiary's suit for the price be dismissed with prejudice.

18 In the following cases, a beneficiary's release of the customer on the underlying contract was held to be insufficient to relieve the issuing bank of its obligation under the letter of credit: Asociacion De Afiucarenos De Guatemala v. United States Nat'l Bank of Or., 423 F.2d 638 (9th Cir. 1970); Housing Sec. Inc. v. Maine Nat'l Bank, 391 A.2d 311 (Me. 1978). We feel that this is an incorrect conclusion. The settlement in *Clement* apparently contained no reservation of rights against the issuer of the letter of credit. Hence, the result will probably be that the issuer will sue the account party for reimbursement, if no voluntary reimbursement is given. The account party probably will then sue the beneficiary for depriving it of the benefit of the settlement and for unjust enrichment. This creates circuity of action. In the case of accommodation parties, the Code protects the principal debtor's settlement by discharging secondary parties unless rights to hold the secondary party liable are expressly reserved, a rule really designed to give the party buying a release the full protection of an unconditional release without altering the rights of the accommodation party. See M. Campbell, *Protection Against Indirect Attack*, in *Harvard Legal Essays* 3-37 (1934).

There are also the rules of real defenses against a holder in due course. See *supra* note 12. The rules do not appear to have diminished the celerity and certainty of the use of negotiable instruments. We suggest that it would not be detrimental to the use of letters of credit to add an unconditional discharge to the "fraud in the transaction" rule for the protection of the account party. Drawing after a settlement with the account party may not be fraud, but it is close to it. There would be no letters of credit if there were no account parties; account parties, therefore, deserve some protection so that they will keep on buying letters of credit.
lation. If the notice of cancellation is from the account party only, then a “may honor” rule — similar to the fraud in the transaction rule — should apply.

Where the insolvency of a party causes a contract to fail, the relevant terms of that party’s insolvency system and the application of those terms to letters of credit become most important. Malynes was quite right: before entering into a letter of credit transaction, an account party agreeing to cancellation should obtain a surrender of the letter or “bee well advised” of the risk involved.

2. The Strict Compliance Rule

In addition to the “independence” principle, the law of letters of credit contains the principle of “strict compliance.” As set forth in Equitable Trust Co. v. Dawson Partners Ltd., the “strict compliance” principle provides, “[t]here is no room for documents which are almost the same, or which will do just as well.” As with many quaint say-

\[\text{17} \quad 27 \text{ Lloyd's Rep. 49 (H.L. 1926).}
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\[\text{18} \quad \text{Id. at 52. See also Corporacion de Mercadeo Agricola v. Mellon Bank Int'l, 608 F.2d 43, 47 (2d Cir. 1979) ("[I]t is black letter law that the terms and conditions of a letter of credit must be strictly adhered to . . . "); Fidelity Nat'l Bank v. Dade County, 371 So.2d 545, 546 (Fla. Dist. Ct. App. 1979) ("Compliance with the terms of a letter of credit is not like pitching horseshoes. No points are awarded for being close."). The quoted statements should be read while keeping firmly in mind what Lord Mansfield said over two centuries ago in Miller v. Race, 1 Burr. 452, 97 Eng. Rep. 398 (K.B. 1758): "It is a pity that reporters sometimes catch at quaint expressions that may happen to be dropped at the Bar or the Bench; and mistake their meaning." Id. at 457, 97 Eng. Rep. at 401. In Equitable Trust, a requirement of two certificates from inspectors was not satisfied by a certificate from one inspector, even though he was the only one there, because a letter of credit requires exact compliance as to substance.

The rule of “strict compliance” holds that the beneficiary's presented documents must comply strictly with the terms contained in the letter of credit. Does strictly mean exactly as to verbalization or exactly as to substance? The vast majority of cases adhere tenaciously to the rule, requiring that the credit be strictly construed and performed precisely in accordance with its terms. See, e.g., Beyene v. Irving Trust Co., 762 F.2d 4 (2d Cir. 1985) (The misspelling of the Arabic name Sofan as “Soran” in the bill of lading was a material discrepancy justifying dishonor of the letter of credit. The court stated, "[I]iteral compliance is essential so as not to impose an obligation upon the bank that it did not undertake and so as not to jeopardize the bank's right to indemnity from its customer."); Banco Nacional v. Mellon Bank, 726 F.2d 87 (3d Cir. 1984) (An amended letter of credit called for a written notification from the seller that the goods had arrived in the United States and the failure of such notification to be tendered was a violation of strict compliance standards justifying the issuer's dishonor because there was no linguistic equivalence.); Board of Trade v. Swiss Credit Bank, 728 F.2d 1241 (9th Cir. 1984) (The letter of credit requiring a bill of lading evidencing marine shipment and beneficiary's tender of an airbill was not in compliance, justifying issuer's dishonor.); Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230 (5th Cir. 1983); Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, 707 F.2d 680 (2d Cir. 1983); Marino Índus. Corp. v. Chase Manhattan Bank, 686 F.2d 112 (2d Cir. 1982).}
ings contained in the reported decisions, the Equitable Trust words are appealing, but give no reason for the rule that controls their application. A preferred alternative principle is that courts should consider linguistic equivalency; that is, saying the same thing in different words should satisfy strict compliance, and a legal successor of an entity should be treated as the same entity.

2.1. Three Justifications for Strict Compliance

In justifying the "strict compliance" rule, the following questions arise: (1) Is the rule's origin analogous to the "ribbon matching" theory of common law contract that has long governed offer and acceptance? or (2) Does the rule's origin stem from banking practice where, as Professor Dolan points out, "[the cases suggest that the strict-compliance rules may be used against any party (issuer, account party, or beneficiary) who wishes to alter the credit terms after establishment by adding or, by implication, subtracting terms]." J. DOLAN, supra note 6, at ¶ 4.08.


In this connection, a recent British case provides interesting deviance to the "strict compliance" rule. Banque de l’ Indochine et de Suez v. J.H. Rayner (Mincing Lane) Ltd., [1983] 2 W.L.R. 841, 859-60 (C.A. 1982) (Kerr, L.J. concurring). In particular, Lord Justice Kerr stated:

For the purpose of considering this point one must assume that, at the time when payment was agreed to be made . . . the confirming bank was convinced that the documents did not comply with the terms of the credit in all respects, but that the beneficiary was convinced that they did, and that the correct answer as a matter of law was uncertain. In this connection it is interesting that it appeared from the expert evidence at the trial that as many as two-thirds of presentations of documents against confirmed credits in London are thought to deviate from the terms of the credits in some respects, but in the great majority of cases this is somehow overcome by agreement.

Id. See infra Section 2.3.1. At common law, any purported acceptance which added qualifications or conditions, even as to a trivial or immaterial detail, operated as a counter-offer, and a rejection of the original offer. J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS 68 (2d ed. 1977). As one court aptly noted, "acceptance [of an offer] must be ‘positive, unconditional, unequivocal and unambiguous’ and must not change, add to or qualify the terms of the offer." Wagner v. Rainer Mfg. Co., 230 Or. 531, 538, 371 P.2d 74, 77 (1962) (citing Shaw Wholesale Co. v. Hackbarth 102 Or. 80, 94, P. 1066, 1067 (1921). The result was a phenomenon known as the "battle of the forms," in which each party, in essence, claimed the benefit of the terms contained in his form over those contained in the other's form.

The drafters of the Uniform Commercial Code sought an armistice to the "battle" by drafting U.C.C. § 2-207, which substantially altered the common law rule. See Hohenberg Bros. Co. v. Killebrew, 505 F.2d 643 (5th Cir. 1974); Dorton v. Collins & Aikman Corp., 453 F.2d 1161 (6th Cir. 1972); Murray, The Chaos in the Battle of the
with strict compliance, bankers were more certain of obtaining reimbursement from the account party without litigation?\textsuperscript{21} or (3) Is the rule based on nothing more than the pragmatic considerations that the bank clerks and lower level supervisors must initially determine compliance of documents, and they must be provided with a rule that can be easily and quickly applied?\textsuperscript{22}

Of course, the strict compliance rule can be abused where considerations other than the variance in the documents appear to have induced the bank not to pay under its letter of credit. In the cases there seems to be, as the First Circuit said, "some leaven in the loaf of strict construction."\textsuperscript{23} Professor Dolan has written that some cases purport-

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\textsuperscript{21} See infra Section 2.3.2. Super strict and ribbon matching compliance ensures the success of a motion for summary judgment against a recalcitrant account party. We submit that under the rule of common understanding advocated here, the same result can be achieved, as the issue of identical legal significance of the words is a question of law, not a question of fact for a jury. Such a rule may well result in a reduction of the two-thirds of all "deviating" presentations in London and would assist in obtaining agreements on the others. See supra note 19.
\textsuperscript{22} Bank clerks and lower level supervisors are people working at a level where knowledge of the nuances of the innumerable trades and trade terms involved in the letter of credit cannot properly be required. See infra Section 2.3.3. The senior author has often heard the late Dean Sola Menschikoff advance this theory and then show that the theory is weakened when banks advertise that their expertise in foreign trade will satisfy all of a client's banking needs. See generally Menschikoff, Letters of Credit: The Need for Uniform Legislation, 23 U. Chic. L. Rev. 571 (1956) (United States and foreign banks do not uniformly employ letter of credit transaction forms).
\textsuperscript{23} Banco Espanol de Credito v. State Street Bank & Trust Co., 385 F.2d at 234 (1st Cir. 1967), cert. denied 390 U.S. 1013 (1968). Query: Is it really "leaven" or is it just the court's "quaint expression" stating that it finds the identical thing simply stated in different terms?

The reference in the Banco Espanol case is indicative of the increasing recognition of a claimed minority standard of documentary compliance known as "substantial compliance." The effect of applying a standard called "substantial compliance" is to compel issuing banks to honor letters of credit even where the presented documentation fails to conform strictly (i.e., \textit{in haec verba}) to the terms contained in the credit. For cases giving explicit recognition to a "substantial compliance" standard, see Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank, 569 F.2d 699 (1st Cir. 1978) (substantial compliance found where the letter of credit required that each draft must be accompanied by "your signed statement that the draft is in conjunction with" the specified underlying contract and the actual statement submitted stated that the letter of credit, not the draft, was in conjunction with the specified documents); Bank of Am. Nat'l Trust & Sav. Ass'n v. Liberty Nat'l Bank & Trust Co., 116 F. Supp. 233 (W.D. Okla. 1953), aff'd, 218 F.2d 831 (10th Cir. 1955) (substantial compliance not found where the letter of credit required a "clean" bill of lading but the bill of lading actually tendered had carrier's disclaimers for damage to goods and carrier had stamped the bill of lading with the legend "Ship not responsible for rust"); First Nat'l Bank v. Wynne, 149 Ga. App. 811, 256 S.E.2d 383 (1979); First Arlington Nat'l Bank v. Stathis, 90 Ill. App. 3d 802, 413 N.E.2d 1288 (1980).

Yet many of these cases involve no more than verbalistic variations in stating what was required. Most of the scholarly commentary is antagonistic to the use of a standard
edly weakening the strict compliance rule should have been decided by an application of a waiver or estoppel approach. Still, courts must know that using such an approach tends to defeat any claim for reimbursement from the account party: the rule of estoppel is based on an assumption that the documents tendered are not conforming, but the bank, by its prior conduct and the potential detrimental reliance of the account party, has precluded itself from making the assertion.

Based of diminished compliance in letter of credit transactions. As Farrar states: "Reasonable compliance also frustrates the effective use of letters of credit, since those who review documents tendered pursuant to a letter of credit will . . . be required to make subjective judgments about what is reasonable." Farrar, Letters of Credit, 38 Bus. Law. 1169, 1174-75 (1983).

In accord is Professor Dolan, who says:

[the substantial compliance approach] does not lend itself well to the bank letter-of-credit department, where document examiners must review the documents against the credit and decide promptly whether to honor the beneficiary's draft. The kind of inquiry that the minority rule commands take more time and requires more legal analysis than document examiners can give and more than the credit transaction can afford.

J. Dolan, supra note 6, at ¶ 6.02. It should be noted that document examiners have three days under U.C.C. § 5-112, whereas personnel in the collection department, checking documents with their authority to pay, have only until the close of business on the day of presentation under U.C.C. § 3-506.

Harfield is slightly bolder in his assessment:

The rigid rules that govern letters of credit are structural. If they are subordinated to more pliable precepts appropriate to equitable resolution of disputes, the very existence of the letter of credit as a useful business device can be destroyed as surely as a wisteria vine can strangle an oak.


"In a number of situations, however, it is not necessary for the parties to deal with the issue of strict or substantial compliance. In these cases, the issuer has waived or ratified the defect or is estopped to assert it." Dolan, Excuse for Beneficiary Non-performance Under a Letter of Credit: Waiver, Ratification and Estoppel, ALI-ABA Course of Study: Letters of Credit 183 (1986). Professor Dolan cites Temple-Eastex Inc. v. Addison Bank, 672 S.W.2d 793 (Tex. 1984) (which is discussed infra notes 39, 44, & 54 and accompanying text) and Crocker Commercial Servs. Inc. v. Countryside Bank, 538 F. Supp 1360 (N.D. Ill. 1981). In Crocker Commercial Servs., the alternate holding was an estoppel based on receipt of documents and a failure to object to them until it was too late for a "cure." Yet it was clear that the invoices presented, with Crocker Commercial Services as assignee, were exactly what was to be financed. Hence, a ruling that the presentation was in compliance with the letter of credit, despite the court's aspersions as to the nature of the bank's conduct, paved the way for reimbursement. However, the account party was in bankruptcy. Isn't a beneficiary in actual, if not strictly verbal, compliance entitled to some consideration? Where the very risk — the account party's bankruptcy — that caused the beneficiary to require a letter of credit actually occurs, should verbalistic variations in saying the thing requested or slight variations in translations destroy the protection? We suggest answers in the negative. We do not suggest a standard of diminished compliance. With a good bank procedure manual, compliance examination can be accomplished in a timely manner.

The U.C.P. has incorporated an estoppel-type provision in Articles 16(c), (d), and (e), requiring the issuer to give expeditious notice stating the discrepancies causing a refusal to pay. Failure to give timely and sufficient notice precludes any claim by the
on the three questions posed above, the authors tentatively suggest that at least some of the cases are applications of the Latin maxim *Cessante ratione legis, cessat et ipsa lex.*

2.2. Example Cases

To make this point, we will apply the assumptions underlying each of our questions to the facts of several recent cases, which we number for purposes of subsequent reference.

*Case No. 1:* In *Tosco Corp. v. F.D.I.C.*, the letter of credit called for the draft to state that it was “[d]rawn under Bank of Clarksville

 issuer that the documents are non-conforming. *See, e.g.*, Apex Oil Co. v. Archem Co., 770 F.2d 1353 (5th Cir. 1985) (giving only one ground for rejection waives all others); Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 236 (5th Cir. 1983); Crocker Commercial Servs., Inc. v. Countryside, 538 F. Supp. 1360 (N.D. Ill. 1981) (silence operates to waive only curable defects); Exchange Mutual Ins. Co. v. Commerce Union Bank, 686 S.W.2d 913 (Tenn. Ct. App. 1984); European Asian Bank A.G. v. Punjab & Sind Bank (No. 2), [1983] 1 W.L.R. 642 (C.A.) (citing equivalent § 8(a)-(g) of the 1974 U.C.P version). No request by the beneficiary for a statement of the discrepancies is required. In this respect, the U.C.P. differs from the terms of U.C.C. § 2-605, which requires, on a merchant buyer's rejection, a seller's written request for a statement of discrepancies only if the time for cure has passed, where the defect, as in letter of credit documents, "is ascertainable upon reasonable inspection." U.C.C. § 2-605.

The trouble with waiver and estoppel approaches is that they leave the issuer at the mercy of the account party, who may successfully claim no obligation to reimburse. Since the account party selected the issuer, as between beneficiary and account party, perhaps the waiver or estoppel should be binding on the account party in the absence of bad faith on the part of the issuer. At any rate, consideration should be given to whether a strict application of the strict compliance rule is used more times by banks and account parties due to changes in circumstances not constituting a proper excuse than to protect against improper substantive performance. The "legal equivalence" or "substantive identity" test we propose may, in fact, cut down on unjustified refusals to pay based on inconsequential discrepancies, thus enhancing the value of letters of credit.

26 "The reason of the law ceasing, the law itself also ceases." BLACK'S LAW DICTIONARY 207 (5th ed. 1979).

27 723 F.2d 1242 (6th Cir. 1983) (There was no discussion of whether these were real defects or whether changed conditions in the status of the beneficiary had threatened realization on the bank's right to reimbursement.). In Forestal Mimosa Ltd. v. Oriental Credit Ltd., [1986] 2 All E.R. 400 (G.A.), Sir John Megaw, writing for a unanimous panel of the Court of Appeal and applying a rule of strict compliance, found no merit in seven argued discrepancies. Two examples indicate the type of objection made. One objection was a declaration that the vessel was not under Israeli, Taiwanese or South African flag and would not call at ports in those countries prior to discharging at Karachi. The declaration was dated July 17, when the ship did not sail until July 20 and could have changed its intentions in the interim but had not. Another was that the bill of lading was signed on July 20 in Bremen, Germany and the vessel sailed on July 20 from Beira, a port in Mozambique. The argument was that either the dates showed a basis for questioning their genuineness or they were signed later and antedated. On just the facts stated, the court did not regard the points as arguable. *Id.* at 408. After all, radio communications do exist and where air freight is used "destination issued bills" may increase in quantity of usage.
Letter of Credit Number 105. In fact, the draft presented stated, "[d]rawn under Bank of Clarksville, Clarksville Tennessee, letter of Credit No. 105." The recipient claimed the benefit of the "strict compliance" rule due to the emphasized differences, and payment was refused. The court held that payment should have been made on presentation.

Case No. 2: In Brown v. United States Nat'l Bank the letter of credit called for "a certificate that the amount drawn is due." Presented was a signed statement that "[t]he amount drawn is due," but words such as "I hereby certify" were not used. The Nebraska Supreme Court held that payment should have been made.

Case No. 3: In American Air Lines, Inc. v. F.D.I.C., the letter of credit called for a draft stating that it was drawn under the bank's "Letter of Credit No. G-301." The draft presented stated that it was drawn under "Letter of Credit G039." The claim was made that a mere typographical error in the digits should not destroy factual conformity. The court ruled that payment should have been made.

Case No. 4: In Beyene v. Irving Trust Co., the letter called for bills of lading naming "Mohammed Sofan" as the "notify party," whereas the bill of lading called for notification to one "Mohammed Soran." The Second Circuit Court of Appeals concluded that the bank was justified in not paying.

Case No. 5: In Mount Prospect State Bank v. Marine Midland Bank, the letter of credit required bills of lading evidencing shipment to "various Magic Automotive Products of Illinois locations in the United States." Invoices presented were to "MAP [Magic Automotive Products] of Maryland, Sy Norman in Massachusetts" and other differently named dealers in Magic Automotive Products. The bank's refusal to pay was held proper. The documents were classified as non-conforming.

Case No. 6: In Temple-Eastex Inc. v. Addison Bank, the credit was issued naming "Woodward, Incorporated" as the beneficiary. The

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28 Tosco Corp., 723 F.2d at 1247 (emphasis added).
29 Id. (emphasis added).
31 Id. at 688, 371 N.W.2d at 696.
33 Id. at 200 (emphasis added).
34 Id. (emphasis added).
35 Id. at 201.
36 762 F.2d 4 (2d Cir. 1985).
38 Id. at 297, 459 N.E.2d at 981.
39 672 S.W.2d 793 (Tex. 1984).
language, directed at Woodward, specified that the money would be “available by your sight drafts drawn on us and accompanied by your affidavit of default that” a named party had defaulted on invoices. No draft was presented, only a letter of demand and an affidavit, both of which were signed by officers of Temple-Eastex Incorporated. In fact, Temple-Eastex was the sole stockholder of Woodward and had dissolved Woodward into Temple-Eastex. The court held that the draw was proper although the papers presented did not include any documentation as to the dissolution of Woodward.

2.3. Justifications for the Strict Compliance Rule and the Cases

When we consider the three questions regarding the policy underlying the rule of strict compliance in light of the results in these six cases, do we gain any insight as to a consistent principle to be distilled from all the cases?

2.3.1. The “Ribbon Matching” Justification

Under the “ribbon matching” theory of the common law, several of these cases were wrongly decided, particularly Case Nos. 2, 3, and 6. In each, under a literal and strict application of the language of the letter of credit, the documents did not comply. Yet, a desirable result was achieved in each.

In any event, the strict “ribbon matching” theory does not have much sensible policy to support it in either the common law of contract, or under Article 2 of the Uniform Commercial Code. Hence, it should not be applied in the case of letters of credit, and certainly not to the extent urged by counsel for the bank in Case No. 1. There, the documents were not “almost the same” — they were the same.

2.3.2. The Reimbursement Protection Justification

The second justification for the rule of strict construction is that it protects the issuer’s ability to promptly obtain reimbursement for payment, without undue interference, from the account party or some other source. The issuer’s suit for reimbursement should depend on whether the account party received that for which it had bargained.

In the case of letters of credit involving payment for goods, absent a substantial change in market price or a dispute about the quality of

40 Id. at 795 (emphasis added).
41 See J. CALAMARI & J. PERILLO, supra note 19.
42 See U.C.C. §§ 2-204, 2-206, 2-207.
goods, account parties will pay to get the goods if they are still in business. In addition, if payment is proper, the goods are usually collateral for the reimbursement. Market price changes are, however, a risk borne whenever collateral is accepted or goods are purchased. If the issuer has paid, market changes should not give the account party any excuse for refusing reimbursement where the documents are sufficient to assure possession for the account party of the very goods called for in documents to be submitted under the letter of credit.

If the discrepancies in the document are so insignificant that the presented documents are, in a business sense, identical to those specified in the letter, the issuer should be compelled to pay. The same documents will be sufficient to compel reimbursement, at least if the issuer and account party are in the same jurisdiction, or there is a proper choice of law clause in the issuer-account party contract. Also, the strict construction principle should not be used to enable issuers to refuse to pay what would otherwise be paid simply because the account party has or is about to become insolvent. That is a risk assumed by all issuers. As Malynes would have put it, the risk is one which the issuer should "bee well advised before hee doe make" the letter of credit.

Are the problems any different in standby letters of credit? Once the element of the account party's insolvency is removed from the reasons which can cause the issuer to refuse payment, the remaining problems are easier to solve. If the wording as to required documents has the same meaning in the account party-issuer contract as the words in the issuer-beneficiary obligation, then what satisfies one contract will satisfy the other. Therefore, with the standby letter of credit, the reimbursement issue is whether the documents fully comply.

Case No. 1 was properly decided under the protection of the right to reimbursement rule. It was drawn on the correct bank, and this fact

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43 A standby letter of credit is a credit which is not a commercial credit, and is designed to be payable in the event of default or other non-performance by a party obliged to the beneficiary. The event triggering payment is to be satisfied by the presentation of documents. J. Dolan, supra note 6, at A-53 (citing Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 113 (Tex. 1978)). The Federal Reserve Board defines a standby letter of credit as any letter of credit which represents an obligation to the beneficiary on the part of the issuer (i) to repay money borrowed by or advanced to or for the account of the account party, or (ii) to make payment on account of any evidence of indebtedness undertaken by the account party, or (iii) to make payment on account of any default . . . by the account party in the performance of an obligation.

12 C.F.R. § 208.8(d) (1987). Equivalent definitions are given by the Comptroller of the Currency, 12 C.F.R. § 32.2(e) (1987), and the F.D.I.C., 12 C.F.R. § 337.2(A) (1987).
could not be denied by the account party.

In Case No. 2, the result is also proper, since the words "I hereby certify" add nothing of substance to the words "the amount is due." Both are mere representations as to a fact. Had the letter of credit called for an affidavit, the difference would be of some significance since a falsehood under oath can have consequences different from those of an incorrect representation.

Case No. 3 involves merely the identification of the letter of credit from the bank's point of view. The number of the letter of credit is of no significance to the account party. Because the bank has three days in which to determine the conformity or non-conformity of documents, and because other submitted documents properly identified the account party, the case was correctly decided.

In Case No. 4, if there was no "Soran" at the notify address and the person at the address was the correct "notify" party, then reimbursement should not be affected. If this was the only issue, then, under the "protection of the right of reimbursement" theory, the case would have been wrongly decided. Likewise, the wrong decision would have been reached in Case No. 5, where the bills of lading were to the intended recipients.

Case No. 6 was properly decided, because the recipient of the goods asserting default was the intended recipient of the disbursement under the letter of credit. It was acting by a statutory successor. But one must still ask whether the statutory succession in *Temple-Eastex* changed the credit risk of the account party in the underlying contract. It is clear that the account party has agreed to pay on documents and adjust any warranty or other non-performance claims with the "recipient of money" in the transaction. Should a merger or corporate dissolution into a sole shareholder affect that interest — to the extent that the bank had paid — could the account party have successfully defended against a claim for reimbursement? The determination to be made is similar to those arising under the law as to delegation of contract duties, where it seems that a delegation cannot be made where credit risks are affected. The decisions in those cases, however, focus

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44 In essence, the documentary sale or documentary draft transaction entails the seller's use of documents embodying title to the goods and the right for delivery to be withheld from the buyer until the buyer either pays for them or, when permitted by instructions, signs a negotiable instrument promising to pay. J. Dolan, supra note 6, at ¶ 1.01[2]; see Chadsey, Practical Effect of the Uniform Commercial Code on Documentary Letter of Credit Transactions, 102 U. Pa. L. Rev. 618 (1954). The same effect also results where the sale is C.I.F. except that the time for examination of the C.I.F. draft with documents is far shorter. See U.C.C. § 2-320(4).

45 See, e.g., Devlin v. Mayor, 63 N.Y. 8 (1875); British Waggon Co. and Park-
on a delegation of full performance. The issue here is a delegation of the right to receive a default payment. The case is not unlike the case where a creditor has assigned rights to payment to a bank, and payment in full has been made before discovery of a latent defect in the goods sold. Upon discovery of the defect, no right of recovery against the assignee bank exists, and the debtor-obligor's rights of recovery still exist against the original creditor's successors, as there had been a succession. Hence, under the principle of protecting the right of reimbursement, Temple-Eastex was correctly decided.

2.3.3. The Pragmatic Banking Justification

The key problem arises under the third justification: whether, pragmatically, there is a bright-line rule capable of being applied by the personnel examining documents for the banks. In our six cases, the courts ruled that payment should have been made in four: Nos. 1, 2, 3, and 6. In Nos. 4, and 5, the courts held that non-payment by the bank was justified, although neither of the first two justifications seem to justify the action.

The cases seem justified under the third justification. While bank personnel cannot be expected to know whether there is any trade difference between "coromandel ground nuts" and "machine shelled ground-nut kernels," or "[d]ried grapes" and "raisins," they can be ex-
pected to know that there is no difference between “Letter of Credit Number 105” and “letter of Credit No. 105.” Bank personnel can also be held to know that “Bank of Clarksville” and “Bank of Clarksville, Clarksville, Tennessee,” are one and the same, especially when it is their own bank. Nevertheless, in Case No. 5 the court correctly determined that bank personnel could not be expected to know that “Sy Norman in Massachusetts” was another name for “Magic Automotive Products of Illinois.” Nor, when foreign names are involved, would it have been appropriate to hold in No. 4 that bank clerks should know that “Soran” is a typographical error for “Sofan.” However, if the two did sound alike, should a court, which customarily applies the doctrine of *idem sonans* to determine the effectiveness of a recorded deed apply that rule to foreign names in a letter of credit, or indeed to any names in a letter of credit? Real estate title searches are conducted in a more leisurely fashion by trained researchers with transactional time to investigate such discrepancies. The practice in letters of credit is quite different. The documents must be examined and the bank must make a rapid decision. The allotted time is short: a decision must be made and a dispatch sent before the close of business on the third day after presentment. The fees are not large and electronic inquiry is inexpensive.

Atterbury Bros., 226 A.D. 117, 234 N.Y.S. 442 (App. Div. 1929), aff’d, 253 N.Y. 569, 171 N.E. 786 (1930) (Letter of credit specifying “casein” was satisfied by shipping documents for “underground casein.”).

49 Sounding the same or alike; having the same sound. A term applied to names which are substantially the same, though slightly varied in spelling, . . . Under the rule of ‘idem sonans,’ variance between allegation and proof of a given name is not material if the names sound the same or the attentive ear finds difficulty in distinguishing them when pronounced.


The doctrine exists with respect to recording acts. A recorded document under a name spelled differently from the true spelling of a party’s name is still constructive notice to one searching the title of a party under the party’s correctly spelled name, if the usual pronunciation sounds the same (“Broun” and “Brown,” for example). The Russell Index System was devised to place all such names together by subdivisions in the indices under the order in which certain liquid consonants appear. See Leary & Blake, Twentieth Century Real Estate Business and Eighteenth Century Recording, 22 Am. U.L. Rev. 275, 285 n.35 (1973).

80 U.C.C. 5-112 states in part:

(1) A bank to which a documentary draft or demand for payment is presented under a credit may without dishonor of the draft, demand or credit

(a) defer honor until the close of the third banking day following receipt of the documents; and

(b) further defer honor if the presenter has expressly or impliedly consented thereto.

The U.C.P., in article 16(c), only prescribes a “reasonable time” which, depending upon the circumstances, could be far shorter or perhaps somewhat longer. See generally Ellinger, The Uniform Customs Their Nature and the 1983 Revision, 1984 Lloyd's
Hence, the rules for compliance and non-compliance could be called rules for determining the obvious, in light of the understanding and vocabularies of ordinary bank clerks and supervisors with a modicum of training.

On this basis, the courts should consider whether the documents presented are, under a typical bank inspection, the identical things called for by the letter of credit. Thus, in Case No. 3, the issue is

Mar. & Com. L.Q. 578. The authors have seen standby letters of credit requiring that the beneficiary receive to its credit “actual and finally collected funds” within 60 minutes of the presentation of documents, the credit usually being to an account with the paying bank, often also the issuing bank. If the credit is subject to both the U.C.C. and the U.C.P., the outside time limitation is that set forth by the U.C.C. See Bank of Cochin, Ltd. v. Manufacturers Hanover Trust Co., 612 F. Supp. 1533 (S.D.N.Y. 1985), aff’d, 808 F.2d 209 (2d Cir. 1986). But the freedom of contract permits a contractual shortening of the time for payment.

The language of a letter of credit is strictly construed against the issuer, or, in some cases, the drafter (if other than the issuer). See, e.g., Banque Paribas v. Hamilton Indus. Int’l, Inc., 767 F.2d 380 (7th Cir. 1985) (ambiguities over whether the standby letter of credit incorporated, as per the underlying contract, a guarantee which may have been violated under Saudi Arabian law, was construed against drafter); Marino Indus. Corp. v. Chase Manhattan Bank, N.A., 686 F.2d 112 (2d Cir. 1982) (“The corollary to the rule of strict compliance is that the requirements in the letter of credit must be explicit . . . and that all ambiguities are construed against the bank. Since the beneficiary must comply strictly with the requirements of the letter, the beneficiary must know precisely and unequivocally what those requirements are.”); East Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co., 593 F.2d 598 (5th Cir. 1979) (The bank attempted to draft a guaranty letter of credit on a form designed for a letter of credit involving a sale of merchandise, thereby making the attempt to specify required accompanying documents meaningless. The ambiguity over accompanying documents was resolved against the bank drafter, and no accompanying documents were found by the court to be required.); Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co., 612 F. Supp. 1533 (S.D.N.Y. 1985) (against the party providing the language); United States Steel Corp. v. Chase Manhattan Bank, N.A., No. 83 Civ. 4966 (S.D.N.Y. July 2, 1984) (against issuer); West Virginia Hous. Dev. Fund v. Stroka, 415 F. Supp. 1107 (W.D. Pa. 1976) (against issuer); Travis Bank & Trust Co. v. State, 660 S.W.2d 851 (Tex. Ct. App. 1983) (against beneficiary drafter); Banco Espanol de Credito v. State St. Bank & Trust Co., 385 F.2d 230, 237 (1st Cir. 1967), cert. denied, 390 U.S. 1013 (1968) (quoting Fair Pavilions, Inc. v. First Nat'l City Bank, 24 A.D.2d 109, 112, 264 N.Y.S.2d 255, 258 (1965), rev’d, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967)) (Courts should construe the language of the credit “as strongly against the issuer as a reasonable reading will justify.”).

Professor Dolan notes, however, that the issuer of the credit is not always the drafter of its terms. Rather, the customer and the beneficiary usually negotiate some of the provisions of the credit. J. Dolan, supra note 6, at ¶ 4.08[3]. He concludes that, “[a] general review of the cases indicates that some courts construe the ambiguous credit against the drafter and that some construe it against the issuer.” Id.

Minimizing conflicting interpretations and potential litigation requires avoiding ambiguity by thoughtful drafting, while keeping in mind the rule of strict construction against the issuer and/or drafter. The parties can draft a letter of credit to best serve the particular circumstances of their transaction. See Comment, "Unless Otherwise Agreed" and Article 5: An Exercise in Freedom of Contract, 11 St. Louis U.L.J. 416 (1967). However, the credit should be carefully prepared to reflect the needs of the parties including the beneficiary and to protect the interests of the issuer. See Del
whether a wrong number on the letter of credit would preclude a cost effective examination of the documents. If the files of the bank's letter of credit department are in numerical order only, and if the number calls up an obviously incorrect file, or is of a letter not yet issued, the issue is whether the filing system was designed with reasonable care if it lacks cross-indices by name of account party and beneficiary. The problem is similar to the problem of the computerized processing of stop orders on checks, except that the gross transactional volume in


Specifically, we point out here that a "clean on-board bill of lading" is not rendered nonconforming because noted thereon is a record of a subsequent unloading by reason of damage caused by a fire on the vessel. See M. Golodetz & Co. v. Czarnikow Rionda Co., Inc., [1980] 1 W.L.R. 495 (C.A.) (Sir John Megaw). The ruling was that the notation must bear on the condition of the goods at the time of loading, a point not entirely clear from the first reading of U.C.P. art. 34(b) (1983), which states, "Banks will refuse transport documents bearing such clauses or notations unless the credit expressly stipulates the clauses or notations which may be accepted. But the phrase "such clauses" refers to U.C.P. art. 34(a), which reads, "A clean transport document is one which bears no superimposed clause or notation which expressly declares a defective condition of the goods and/or the packaging." But these refer to conditions at the time of loading, as does article 26(a)(ii), defining a marine bill of lading. And article 34(c) provides, "[b]anks will regard a requirement in a credit for a transport document to bear the clause 'clean on board' as complied with if such document meets the requirements of this article and of article 27(b)." For a discussion of the 1983 revisions to the U.C.P., see Byrne, The 1983 Revision of the Uniform Customs and Practice for Documentary Credits, 102 Banking L.J. 151 (1985); Cannon, The Uniform Customs and Practice for Documentary Credits: The 1983 Revision, 17 U.C.C. L.J. 42 (1984); Chapman, The 1983 Revisions to the Uniform Customs and Practice for Documentary Credits, 90 Com. L.J. 13 (1985).

Bank computers were originally programmed to "kick out" stopped items only by reading the amount of checks to be stopped to the exact penny. As such, several early courts, following the pre-computer precedents of minor errors, found banks liable for failure to stop payment on items. See, e.g., Rimburg v. Union Trust Co. of D.C., 12 U.C.C. Rep. Serv. (Callaghan) 527 (D.C. Super. Ct. 1973) (Where drawer's stop order listed the amount of the check as being for $235.00 instead of $250.00, the bank was held liable, inter alia, for failure to explain to the payor that the computer would only "kick out" the check to be stopped based on the amount being correctly stated); see also Delano v. Putnam Trust Co., 33 U.C.C. Rep. Serv. (Callaghan) 635 (Conn. 1981) (Where the amount stated in the stop order was $555.30, but the check was for $455.30, the bank was held liable for the failure to stop.); Pokras v. National Bank of N. Am., 30 U.C.C. Rep. Serv. (Callaghan) 1089 (N.Y. App. Term 1981) (two cent error by customer, bank liable); Elise Rodriguez Fashions, Inc. v. Chase Manhattan Bank, 23 U.C.C. Rep. Serv. (Callaghan) 133 (N.Y. Sup. Ct. 1978) (Where the amount was given as $1804.10 instead of $1804.00, the bank was held liable for failure to stop.) Thomas v. Marine Midland Tinkers Nat'l Bank, 86 Misc. 2d 284, 381 N.Y.S.2d 797 (N.Y. Civ. Ct. 1976) (Bank was held liable for failure to stop where check number was given as 221 instead of 222, with all information correctly stated.). Banks argue that present computerized processing of checks requires the exact amount and the customer's error should not be charged to the bank. Proper programming can result in a "kick out" of checks with minor variations. See Migden v. Chase Manhattan Bank, 32 U.C.C. Rep. Serv. (Callaghan) 937 (N.Y. Civ. Ct. 1981) (variations up to a
any one bank in letters of credit would be far less than that of checks. In any event, proper file searching can be expected of bank personnel. If cross indexing is unduly expensive, the banks must plead and prove their case on the need for proper letter of credit numbers on the submitted document. In Case No. 3, this was not done.

This leaves Case No. 2 and Case No. 6. These cases depend upon the extent of quasi-legal training that should be expected of the document examiners and reviewers in a letter of credit department. If there is no legal difference between a signed paper saying, "the amounts are due," and one, also signed, saying, "I hereby certify that the amounts are due," simple training can make that clear. It is true that the word "certify" preceding the statement may give a greater aura of formality, but it does not in fact add to the legal effect. Such a determination certainly would require some examination of the content of the presented documents, but no more than is called for by Article 23 of the Uniform Customs and Practices. See J. VERRIER & V. SHUE, CHECKS, PAYMENTS, AND ELECTRONIC BANKING 438 (1986). So too in letters of credit, if the number of the letter is the cause of the dishonor, banks should program their retrieval systems for the customer's convenience and include a customers' name index.

Nor is it difficult to require that bank personnel find a facial compliance between the text of a usual document and what is called for in the letter of credit; this requirement may easily be added to personnel training manuals. Deep reading of complicated documents beyond the initial paragraphs should not be required.

The same approach determines what meaning is to be given to the term "draft" in a letter of credit. Unless specified to be a "negotiable draft," any demand for payment should suffice. This also is not too difficult a concept for bank personnel to keep in mind.

More difficult is the issue of drawing by and certifying by a suc-

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53 See, e.g., U.C.P. art. 37(b) (stating that the amount of the insurance document must at least equal the value of the goods plus 10%, but if that cannot be determined, the insurance amount must cover the greater of the amount drawn or the amount of the commercial invoice); cf. Id. at art. 39 (stating that where an insurance document is to cover all risks, the tendered document must be examined). U.C.P. art. 23, on the acceptance of certain documents "as presented," now has an added proviso, which reads:

[B]anks will accept such documents as presented, provided that their data content makes it possible to relate the goods and/or services referred to therein to those referred to in the commercial invoice(s) presented, or to those referred to in the credit if the credit does not stipulate presentation of a commercial invoice.

Finally, U.C.P. art. 15 requires examination of all documents presented for inconsistency. It states: "Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit."
cessor corporation where no insolvency is involved. *Temple-Eastex Inc. v. Addison Bank* and its progeny have permitted the draw and the certificate by the successor.\(^5\) The right to draw is a contingent, intangible asset of the beneficiary, ripening into a direct asset when the beneficiary has performed the underlying contract. The issue really is whether, in addition to presenting its demand for payment, there should also be some documentation of the presenter's succession to the position of the beneficiary.

In this era of corporate takeovers, the determination of whether the successor corporation becomes a legal successor of the beneficiary, a transferee of the credit, or a mere assignee of the beneficiary's right to the proceeds is an important one, and one on which there is scant authority in letter of credit law. For the application of the third justification of the rule, the first concern is whether, on receipt of a presentation with documentation alleged to show successorship, bank personnel should have some procedure to determine whether to pay or to consult counsel on the matter. If a negotiable draft or certificate — drawn by one other than the named beneficiary without documentation of the succession — is presented, then by analogy to U.C.C. § 3-505(1)(b), the issuer should be able to demand, without dishonor, "reasonable identification of the person making presentment and evidence of his authority to make it."\(^5\) Also, as is prescribed in U.C.C. § 3-505(2), the

\(^{5}\) 672 S.W.2d 793 (Tex. 1984) (parent corporation allowed to draw under credit in favor of dissolved subsidiary and to present its own affidavit in lieu of one by subsidiary); Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399 (1st Cir. 1985); F.D.I.C. v. Bank of Boulder, 622 F.Supp. 288 (D. Colo. 1985) (rights go to State Banking Commissioner and F.D.I.C. as receiver, but F.D.I.C. as receiver cannot transfer rights to F.D.I.C. as corporation); Pastor v. National Republic Bank, 56 Ill. App. 3d 421, 371 N.E.2d 1127 (1977), aff'd, 76 Ill. 2d 139, 390 N.E.2d 894 (1979) (state insurance superintendent allowed to draw against credit in favor of insurance company in liquidation). But see In re Swift Aire Lines, 30 Bankr. 490, 496 (9th Cir. 1983) (Statement signed by bankruptcy trustee for beneficiary failed to comply with credit requiring statement signed by beneficiary's corporate secretary.). See discussion infra text at notes 101-45.

\(^{5}\) U.C.C. § 3-202. This section states:

(1) The party to whom presentment is made may without dishonor require

(a) exhibition of the instrument; and

(b) reasonable identification of the person making presentment and evidence of his authority to make it if made for another; and

(c) that the instrument be produced for acceptance or payment at a place specified in it, or if there be none at any place reasonable in the circumstances; and

(d) a signed receipt on the instrument for any partial or full payment and its surrender upon full payment.

(2) Failure to comply with any such requirement invalidates the presentment but the person presenting has a reasonable time in which to comply
presenter should be given a reasonable time to comply with the identification requirement, which might extend beyond the expiry date if the original presentation is on time. Succession should be treated separately from a transfer or an assignment, both of which are in the nature of consensual transfers. Succession should not require the consent of the issuer, which the issuer could withhold without reason if the credit position of the account party had worsened. Succession should be treated separately from a transfer or an assignment, both of which are in the nature of consensual transfers. Succession should not require the consent of the issuer, which the issuer could withhold without reason if the credit position of the account party had worsened. Where the transaction involves a different party signing an affidavit or statement as to default, a distinction might be drawn based on the implied trust in the integrity of a specially indicated required signer.

There should be some limit to the extent bank personnel are expected to apply legal conclusions to documents presented. However, an English court did expect bank personnel to know that the character of a “clean on board bill of lading” was not destroyed by a notation of the damage to the cargo after it was loaded and partially off-loaded. Cases that treat a beneficiary’s demand for payment as satisfying a call for a “draft,” and treat a statement as satisfying a call for a “certificate” require a certain training in the legal significance of commonly used terms so that the exact legal equivalence of documents commonly presented can be determined. This exact legal equivalence doctrine should not extend to documents not commonly presented, or to specified signatories. It can, however, extend to training to consult counsel on matters of legal succession, or what we might call “entity equivalence.”

2.4. The Correct Strict Compliance Rationale

Based on the foregoing analysis, we may conclude that the reason for the doctrine of strict compliance is that bank personnel should not
be placed in the position of having to determine anything except whether, given common variations in usage of words and some basic training as to the legal effect of commonly used documents and legal successors, the identical thing required has been presented.

We suggest that there should not be a bifurcated standard. Rather, the rule should be that where bank personnel have released payment under a letter of credit, there should be a presumption that the papers which were accepted as complying documents were in fact the identical things required by the language of the letter of credit, or were things required by operation of law to be treated as identical. The account party could, of course, rebut the presumption. When the bank does not pay under a letter of credit, the aggrieved party should be required to demonstrate that what was presented and what was specified in the letter of credit were essentially identical.

3. The Effect of Insolvency

Against this background of the independence principle and what may be called the "linguistic equivalency/compliance principle," we can now discuss the insolvency problems and the essential need that any issuer of letters of credit — especially standby letters — "bee well advised before he doe make them." We assume here that despite the insolvency of a party, a proper presentation of documents can be made in compliance with the foregoing discussion. Specifically, we must determine whether the insolvency of any one or two of the parties requires a different result than the one reached under our foregoing interpretation of the rules of compliance.

3.1. Beneficiary Insolvency

First, we consider the result should the beneficiary become insolvent. We may the beneficiary's representative in insolvency draw on an

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88 We assume here that the representative in insolvency has not rejected, as an executory contract, either the letter or the underlying contract.

One of the three theories advanced in the *Twist Cap* complaint was that the letters of credit were executory contracts that the debtor could reject. See Chaitman & Sovern, *supra* note 2, at 30. Under the Bankruptcy Code, a bankrupt may reject executory contracts with court approval. 11 U.S.C. § 365(a) (1982 & Supp. III 1986) (which provides, in pertinent part: "Except as provided . . . in subsection (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."). While the Bankruptcy Code does not define "executory," the term is generally accepted to mean "a contract under which the obligations, of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973); see also THC Financial.
outstanding letter of credit? The answer is in the affirmative. Should the stage of the beneficiary’s performance of the underlying contract make any difference in the matter? Should the differences between straight credits and negotiation credits have any significance? Answers in the negative to these last two questions are suggested.

Letters of credit are issued in two different categories: straight credits and negotiation credits. This distinction merely gives rights to those included in the negotiation clause of the letter of credit to collect in their own right, rather than as agent for the beneficiary.56 Thus, this distinction should have no bearing on the right of the insolvency representative to draw, as the insolvency representative draws, in the right of the beneficiary rather than as an agent. A problem might exist, how-

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56 A straight credit is that credit which requires that drafts be signed by a designated party, which is usually its authorized agent. The credit usually contains language such as, “Drafts must clearly specify the number of this advice and be presented at this company not later than . . . .” or, “We undertake that all drafts drawn and presented to us as above specified will be duly honored.” J. DOLAN, supra note 6, at A-54; see also Dixon, Iramos & CIA v. Chase Nat'l Bank, 144 F.2d 759, 760 n.1 (2nd Cir.), cert. denied, 324 U.S. 850 (1944); Edgewater Constr. Co. v. Percy Wilson Mortgage & Fin. Corp., 44 Ill. App. 3d 220, 357 N.E.2d 1307 (1976); Mid-States Mortgage Corp. v. National Bank, 77 Mich. App. 651, 653, 259 N.W.2d 175, 176 (1977).

A negotiation credit is one “under which the issuers” engagement runs to drawers, endorsers and bona fide holders of drafts drawn under the credit or under which the issuer indicates expressly that the credit is available via negotiation. J. DOLAN, supra note 6, at A-47; see INTERNATIONAL CHAMBER OF COMMERCE, STANDARD FORMS FOR ISSUING DOCUMENTARY CREDITS 10 (1978) (ICC Pub. No. 323).

The principal distinction between the two types of credits is that in the straight credit, the engagement runs to the beneficiary, while in the negotiation credit, the engagement runs to “drawers, endorsers, and bona fide holders.” J. DOLAN, supra note 6, at ¶ 8.02[6]. The straight credit conveys no commitment or obligation to parties other than the named beneficiary. See Eriksson v. Refiners Export Co., 264 A.D. 525, 35 N.Y.S.2d 829, reh'g denied, 265 A.D. 804, 37 N.Y.S.2d 428 (App. Div. 1942). The negotiation credit, on the other hand, extends the issuer’s engagement, on specified conditions, to third parties who have purchased the beneficiary’s drafts to be presented under the credit. Ryan General Principles and Classifications of Letters of Credit, in 1985 PRAC. L. INST., LETTERS OF CREDIT AND BANKERS' ACCEPTANCES 11, 52-53 (C. Mooney ed.). For further elaboration on the two types of credits, and their distinguishing characteristics, see J. DOLAN, supra note 6, at ¶¶ 10.02[2]-10.03; Harfield, Identity Crisis in Letter of Credit Law, 24 ARIZ. L. REV. 239, 246-248 (1982).
ever, in the case of a straight credit where the draw is by a successor. When the letter does not state it is transferable, it is therefore non-transferable under both the U.C.C.\textsuperscript{60} and the Uniform Customs and Practices.\textsuperscript{61}

This general non-transferability principle in letter of credit law seems to stipulate that only the named beneficiary may draw unless agreement otherwise is specifically set forth. The justifications proposed for the rule lack substance in today's world; they may be remnants of a time when any transfer of an intangible was believed to involve chancery and maintenance.\textsuperscript{62} The old justification — that the account party reposes special confidence in the beneficiary and that permitting others to draw on the letter of credit would betray that trust — will not withstand scrutiny when it is applied to every non-transferable letter

\textsuperscript{60} U.C.C. § 5-116(1) states, "[t]he right to draw under a credit can be transferred or assigned only when the credit is expressly designated as transferable or assignable." See National Bank & Trust Co. of N. Am., Ltd. v. J.L.M. Int'l, Inc., 421 F.Supp. 1269, 1272-73 (S.D.N.Y. 1976); Shaffer v. Brooklyn Park Garden Apartments, 311 Minn. 452, 250 N.W.2d 172 (1977); Eberth & Ellinger, Assignment and Presentation of Documents in Commercial Credit Transactions, 24 Ariz. L. Rev. 277 (1982); McGowan, Assignability of Documentary Credits, 13 Law & Contemp. Probs. 666 (1948); Ufford, Transfer and Assignment of Letters of Credit Under the Uniform Commercial Code, 7 Wayne L. Rev. 263 (1960).

\textsuperscript{61} U.C.P. art. 56(b) states: "A credit can be transferred only if it is expressly designated as 'transferable' by the issuing bank. Terms such as 'divisible,' 'fractionable,' 'assignable,' and 'transmissible' add nothing to the meaning of the term 'transferable' and shall not be used." Id.

\textsuperscript{62} At early common law, any attempted assignment or transfer of a contract right was ordinarily held ineffective. This was particularly true with respect to intangibles — choses in action — which could not be effectively assigned. 1 GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 7.3 (1965). Thus, Lord Coke stated:

And first was observed the great wisdom and policy of the sages and founders of our law, who have provided that no possibility, right, title, nor thing in action, shall be granted or assigned to strangers, for that would be the occasion of multiplying of contentions and suits, of great oppression of the people, and chiefly of terre-tenants, and the subversion of the due and equal execution of justice.

Lampet's Case, 10 Coke 46b, 48a (1612), 77 Eng. Rep. 994, 997 (K.B. 1613); see Glenn, The Assignment of Choses in Action: Rights of bona fide Purchaser, 20 Va. L. Rev. 621, 636 (1934) ("In other words, Coke attributed the rule, that choses in action are not assignable, to outside pressure."). As Calamari & Perillo aptly noted, The history of the law of assignments is an interesting illustration of the struggle between commercial needs and the tenacity of legal conceptualism. The common law developed when wealth was primarily land, and, secondarily, chattels. Intangibles hardly mattered. In a developed economy, however, wealth is primarily represented by intangibles: bank accounts, securities, accounts receivable, etc. The free alienability of these assets is essential to commerce.

where the transfer involves no changed credit risk.

Any draw must be accompanied by the documents which the account party has specified in the letter of credit. Any confidence reposed in the beneficiary relates only to those documents which are, in a commercial letter of credit, turned over to the account party. If the payment gives the account party title to the goods and discharges the payment obligation under the underlying contract, all possible interests of the account party are satisfied. Any claim that a transfer will prevent the account party from asserting offsets against the beneficiary ignores the independence principle and the underlying concept of the documentary sale. The commitment of the issuing bank is to pay the sum specified in, or computed in accordance with, the letter of credit. Even if the beneficiar y were the drawer and the account party had offsets, the offsets could no more be asserted through the issuing bank than any other defenses, absent “fraud in the transaction,” illegality, or evidence satisfactory to the issuer of an unconditional cancellation of the underlying contract.

The next inquiry is whether the issuing bank has any interests that might be involved. Professor Dolan suggests that credit issuers should not be forced to inquire at length into the authority of the drawer; such an obligation would diminish “the celerity of transactions” and cause the acceptability of credits to suffer. He does not suggest that an issuer is denied the right to so inquire should it so desire. Most beneficiaries are corporations, and most letters of credit do not specify who is to sign the draw on behalf of the beneficiary. Hence, issuers must rely on the warranty that the beneficiary has complied with all conditions of the credit. This warranty, however, requires

63 In documentary sales, offsets and breaches of warranty are to be settled by independent suit when conforming documents are tendered. For example, Farrar states “Disputes concerning performance or other matters between seller and buyer (beneficiary and account party) have to be worked out between themselves.” Farrar, Judicial Intervention, in 1986 PRAC. L. INST., LETTERS OF CREDIT & BANKERS’ ACCEPTANCES 651, 654. Professor Clark concurs, saying:

[I]f the buyer fears that the . . . shipment of goods will be non-conforming, he cannot raise . . . breach of warranty as a defense to payment of the price; the buyer’s bank is under a primary obligation to pay the draft so long as the documents conform to the requirements of the letter. Thus, the burden of suit is shifted, and the buyer must go after the seller . . . .


64 See Dolan, Transfer and Assignment of Letters of Credit and Rights Thereunder in ALI-ABA COURSE OF STUDY: LETTERS OF CREDIT 240 (1986).

65 U.C.C. § 5-111 provides:

(1) Unless otherwise agreed the beneficiary by transferring or presenting a
that the beneficiary transfer or present the credit, which would not have been done had the draft or demand for payment been forged. In the usual case, the issuing bank may well be relying on the Articles 3 and 4 warranties of the presenting bank. But because this may only be a warranty of “no knowledge” of forged or unauthorized drawer’s signature to a payor bank, the warranty is a slender reed to rely upon. The same reliance could be made on presentation warranties by the

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insolvency representative of the beneficiary.

The analysis may be different where the insolvency representative executes documents required by the letter of credit, and the account party’s application required the documents to be executed by another individual.67 First we must ask, what of the right to draw? We have already discussed the problem of a draw by a successor under a plan of voluntary liquidation.68 Should not the position of a statutory successor in liquidation be even stronger? In many areas, a statutory successor succeeds where a mere assignee or even a court-appointed receiver would not. For example, where the beneficiary was an insurance company that was in the hands of a state insurance liquidator, the Illinois Supreme Court ruled that the state insurance liquidator could properly draw under the letter of credit.69 Where the letter of credit referred to the Imperial Government of Iran, draws by agencies of the succeeding Islamic Republic were ruled to be proper.70 So too, the Federal Deposit Insurance Corporation (F.D.I.C.), in its capacity as receiver for a failed bank beneficiary, has been able to draw.71 As a receiver in insolvency, the F.D.I.C. customarily draws in the name of the beneficiary by its liquidator, titling itself as such. A federal district court, however, has held that the F.D.I.C. as liquidator cannot transfer the right to draw under a non-transferable credit to the F.D.I.C. in its corporate capacity.72

Including Temple-Eastex Inc. v. Addison Bank,73 the precedent seems to allow the transfer of a beneficiary’s drawing rights to a successor under corporate law, and governmental de facto successors under insurance company insolvency law and banking insolvency law.

Should federal bankruptcy proceedings reach a different result? In In re Swift Aire Lines,74 the Bankruptcy Panel of the Ninth Circuit
Court of Appeals seems to think so. The Ninth Circuit applied section 365(c)(2) of the Bankruptcy Code, which prevents a trustee from assuming any “executory contract . . . if . . . such contract is a contract to make a loan, or extend other debt financing or financial accommodation to or for the benefit of the debtor.” The holding fortunately, is but one of two holdings that favor non-payment by the issuing bank. The

commercial airline service. In November 1980, Justin Colin, the appellant, purchased an 80% stock ownership interest in Swift for $1,775,000. He agreed in a separate investment agreement to contribute an additional $775,000 to Swift, to be made “in the event that either Wells Fargo Bank, N.A., . . . or the Board of Directors of Swift determines in good faith, that such funds are required by Swift for the continuing operation of its business . . .” Id. at 491. Appellant was to deliver to Swift a letter of credit for the $775,000 to secure the additional payment in the event that it was required.

On January 19, 1981, Crocker National Bank, appellant, issued an irrevocable letter of credit for $775,000 pursuant to Colin's application, naming Swift as benefici- ciary. The Board of Directors of both Swift and Wells Fargo were each given the authority to draw against the credit. Id.

The following day, Colin communicated to Wells Fargo that Swift could draw on the letter even if the latter filed for bankruptcy, and that the 11 U.S.C. § 365(e)(2)(B) provisions were waived, and would not be asserted by Colin if Swift attempted to draw on the credit.

As a condition, however, to either Swift or Wells Fargo being able to draw, the letter of credit required a statement that Swift or Wells Fargo demanded payment from Colin of the additional contribution, and that the amount remained unpaid for five days. On September 15, 1981, Wells Fargo made formal demand on Colin for the contribution. On September 18, 1981, and prior to the expiration of the five days, Swift filed a petition for a Chapter 7 bankruptcy. Three days later, the interim trustee was appointed. On October 6, 1981, the trustee presented certain documents to Crocker Bank in an attempt to draw against the letter. Crocker refused to honor the documents, citing failure of the documents to strictly comply with the terms of the credit. The letter of credit required that “draft/s at sight” be presented at the time demand was made under the letter of credit. The court found that although the draft did not bear the words “draft at sight,” the draft, being functionally payable at sight, was in conformity with the letter of credit’s requirements. However, the letter of credit also required a statement from Wells Fargo which was to be manually signed by the beneficiary and followed by the designation “Corporate Secretary, Swift Aire Lines, Inc.” This condition was not met because the trustee in bankruptcy, not the corporate secretary, drew on the letter of credit. Thus, the court held that the bank was justified in dishonoring the letter of credit. Id. at 491-92.

See id. at 496 (substance of first holding). Nevertheless, each ground is a holding binding on lower courts. Based on the law of the case doctrine, the appellate court holding is also binding on a lower court in subsequent proceedings in the same case. Justice Nichols of the Supreme Court of Maine recently defined that doctrine as follows:

As thus applied, the doctrine of the law of the case resembles res judicata, but it is more limited in its application and it is not as rigidly applied. It relates only to questions of law, and it operates only in subsequent proceedings in the same case.

[It is also applied to those situations where], absent a showing of essentially different facts, the decision by an appellate court on a given issue is to be filed in the trial court once the case is remanded, and that the decision by an appellate court controls in subsequent proceedings in the same court.
other holding provided that the standby letter of credit required the corporate secretary of Swift Aire Lines to certify that the funds were needed for the continuing operation of the business, and that these funds had not been furnished. Waving the banner of the principle of strict compliance, the Ninth Circuit proclaimed that the trustee in bankruptcy was a separate and distinct entity from the officers and directors of the bankrupt corporation in a Chapter 7 proceeding.

The case was wrongly decided on both matters. On the "financial accommodation" point, the issuing bank had agreed to give financial accommodation to its account party (who presumably remained solvent), not to the beneficiary. It was the account party's debt that was to be paid, and reimbursement was, of course, to come from the account party as part of a partially completed transaction. There was no financial accommodation to any bankrupt debtor.

We assume that the trustee, under Chapter 7, was continuing to operate the business, and that we do not have here a letter of credit draw as in Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank.

The right to obtain payment of the additional funds, if needed

Blance v. Alley, 404 A.2d 587, 589 (Me. 1979).

Swift Aire Lines, 30 Bankr. at 495-96.


(c) The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignments of rights or delegation of duties, if . . .

(2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor . . . .

After a brief analysis of the legislative history of 11 U.S.C. § 365(c), the Ninth Circuit Bankruptcy Panel in Swift Aire Lines concluded that, "[t]he drafters of the Bankruptcy Code considered that letters of credit were executory contracts to make a financial accommodation to or for the benefit of the debtor." 30 Bankr. at 496. We question the correctness of this conclusion as applied to a bankrupt beneficiary, because a letter of credit is essentially a binding commitment between the issuer and the account party intended as a means of payment by the account party. The independence principle requires that the credit be honored regardless of the status and respective positions, including insolvency, of the underlying parties because honor at the time of presentation is the raison d’être for taking out the standby letter of credit.

757 F.2d (1st Cir. 1985). In the Emery-Waterhouse case, the Rhode Island Hospital Trust National Bank (Hospital Trust Bank) financed the sale of woodburning stoves by the seller, the Franklin Cast Products Company (Franklin). The arrangement consisted of a Hospital Trust Bank loan to Franklin secured by rights in Franklin's accounts receivable. Emery-Waterhouse Company (Emery), a Franklin customer, arranged with its bank, First National Bank of Boston (FNB), to provide Franklin with a standby letter of credit to guarantee payment for all present and future purchases, up to $329,000. The agreement provided that the credit would not be used to pay Franklin; rather, Emery would pay its bills directly to Hospital Trust Bank, after receiving an invoice for payment due from Franklin. Discrepancies between a Franklin invoice and an Emery payment were reconciled via confirmation with Franklin, and were thereafter treated by Hospital Trust Bank as an additional loan to
for the continued operation of the business, was an asset of the bankrupt, and its absence would adversely affect the creditors of the business. The Bankruptcy Code’s language should apply to wholly executory transactions.

The Ninth Circuit did not consider the ability of the trustee to assume the underlying agreement and sue the account party for non-payment thereunder. If that had been the case, the account party would have sued the issuing bank for failure to pay. Since neither of these parties was insolvent, there were no bars to recovery. In this scenario, it should at least be clearer to a court that the bank’s financial accommodation involved in the transaction was for the benefit of the account party, not the beneficiary. The account party’s damages would include any interest collectable by the trustee, as well as any costs or losses incurred by making payment on terms less favorable than those in the reimbursement agreement. If the issuing bank were treated as an indemnitor and, upon notice, failed to defend against the beneficiary, counsel fees would also be recoverable.

Franklin for accounting purposes. Soon thereafter, Franklin became insolvent while still indebted to Hospital Trust Bank for approximately $2 million. Hospital Trust Bank ordered a takeover of the corporation to organize its liquidation, and seized its accounts. Thereafter, Hospital Trust Bank undertook to obtain additional funds by calling upon letters of credit naming Franklin as beneficiary in the aggregate amount of $139,700. Problems, however, arose regarding payment of the drafts, as there was considerable evidence known by or available to Hospital Trust Bank that, in fact, no money was owing from Emery to Franklin. The Hospital Trust Bank officer in charge of liquidation first voiced concern, noting that the Bank’s records were “muddled and incomplete,” and “feared that Hospital Trust Bank was trying to collect money that Franklin’s customers did not owe it.” Id. at 402. Hospital Trust Bank, however, continued to press for payment.

After paying the first of two such drawings, FNB balked at paying the last one, informing Hospital Trust Bank that Emery did not owe Franklin the money. Hospital Trust Bank insisted, however, on payment of the remaining draft, and refused refund of the monies already obtained from FNB.

Soon thereafter, Emery enjoined payment on the final draft. In the interim, Hospital Trust Bank’s own internal investigation confirmed that no money was, in fact, owing from Emery to Franklin. The Bank, however, continued to push for payment, and upon dissolution of the injunction, received the additional $46,000 from FNB.

Emery thereafter filed suit to recover the $139,700 that Hospital Trust Bank had obtained from FNB (who in turn had debited Emery’s FNB account) on the basis that it owed Franklin nothing. The jury agreed, concluding that Hospital Trust Bank should return the $139,700, and awarded Emery an additional $2 million in punitive damages. The district court reduced that award to $1,397,000. On appeal, the judgment and the punitive damage award were affirmed. Id. at 399. The United States Court of Appeals for the First Circuit held, inter alia, that: (1) the bank’s call on the letter of credit was based on a fraudulent draft, and there was fraud in the transaction, since the bank knew some or all of the money was not owed; and (2) punitive damages are permissible where the bank acted in a “willful, reckless, or wicked manner.” Id. at 404-05, 07.

The common law of “vouching” to warranties covers all indemnity relationships. See U.C.C. § 2-607, 3-803. Sometimes it is referred to as a collateral estoppel by
Other issues arise where a necessary statement is not signed by the person or office holder specified in the letter and presumably in the application for the credit. Here, although it may or may not violate the independence principle, the bank cannot tell whether the account party did or did not place particular trust or confidence in the holder of the designated signatory's office as compared to a trustee in bankruptcy. However, if only the title of the office were named, and the account party had no control over who held the office, form should not control substance: was there not, after all, a responsibly signed statement that the business was continuing? Perhaps other elements not discussed in the opinion determined the *Swift Aire Lines* holdings; the issues underlying the holdings could have been more easily discussed in the opinion than whether section 356(c) of the Bankruptcy Code could be extended to the account party who had signed a written waiver, and who obviously would be reluctant to throw good money after bad. However, on the issue of particular trust in the designated signer, the decision seems to indicate a lack of care in the trustee's preparation of the presentation. Why did the trustee not sign as successor to the secretary? If the corporation had not been dissolved, the corporate secretary was, presumably, still alive and able to sign, or one could have been elected by the directors for the purpose. Why was this not done? Otherwise, the case may simply exalt form over substance, or may involve a later, unmentioned dispute over whether what the trustee was doing was a "continuing operation of the business."

In re *Swift Aire Lines* may be a decision peculiar to standby credits and the certificates thereunder required. In the case of commercial credits, a trustee of the beneficiary should be able to draw in the same manner as other statutory successors. Hence, we conclude that there is a difference between naming the particular person and naming the office held. We perceive the latter to be preferable when drafting for the letter of credit transaction, "[i]f [the] issuer will wish to compare signatures on drafts or certificates with exemplars, those who can sign should be named, by office, preferably, and provision made to insure [that the] issuer is supplied with up to date exemplars." See Leary, *Suggestions on Drafting*, in ALI-ABA COURSE OF STUDY: LETTERS OF CREDIT 251-52 (1986). Mr. Davenport is in accord with this assessment, as he recommends specifically identifying the signer of the certificates or affidavit by office, using as examples, "the president of the Indonesian Chamber of Commerce," "weightmaster of the Valetta Port Authority," and "the treasurer of the XYZ Corporation," in lieu of statements such as "issued" or "signed by a competent authority" or "officially signed statements." Davenport, *Letters of Credit: Some Suggestions on Draftsmanship*, in ALI-ABA COURSE OF STUDY: LETTERS OF CREDIT 293 (1985). Due to the fact that such officers at the time of drawing may be different persons from
3.2. Account Party Insolvency

What of the "Tempest in a Twist Cap"?\textsuperscript{82} Does the insolvency of the account party affect the rights of the beneficiary or the obligations of the issuer to the beneficiary? The answer to this, in theory, should be a resounding "No!" The very reason a letter of credit is demanded is that the credit rating and the ability of the account party to pay are not known to, or satisfactory to, the beneficiary. The function of the letter of credit is to shift all risks of non-payment by the account party from the beneficiary to the bank. Under the independence principle, the insolvency of the account party is and should be immaterial once the credit is established as to the beneficiary. The issuing bank may have difficulty in obtaining reimbursement from the estate of the account party, but the bank clearly assumed this risk.

The case that caused all the furor, \textit{In re Twist Cap, Inc.},\textsuperscript{83} was decided on a motion to dismiss a temporary restraining order, and was subsequently settled. The case involved a standby letter of credit required by two suppliers of Twist Cap before they would sell. Judge Paskay's opinion referred to the beneficiaries as "two unsecured creditors" who should not be permitted "to receive a payment, possibly in full, on the pre-petition indebtedness owed to them by the debtor" as it "would amount to an impermissible preferential treatment of these two . . ."\textsuperscript{84} This observation overlooks several crucial factors. The two suppliers were not unsecured from the moment the letter of credit was established for them. Nor was the bank — Twist Cap's inventory financier — unsecured. The bank's security agreement contained an after-acquired property clause and a catch-all future advance clause.\textsuperscript{85} Value was given when the issuing bank gave an irrevocable commitment to a third person, namely the two suppliers. The bank's financing statement was filed over a year before the filing in bankruptcy. The letters of credit were issued as to one supplier over a year before bankruptcy, and more than five months before bankruptcy as to the second supplier.\textsuperscript{86}

\textsuperscript{82} See Chaitman & Sovern, supra note 2.
\textsuperscript{83} 1 Bankr. 284 (S.D. Fla. 1979).
\textsuperscript{84} Id. at 285.
\textsuperscript{85} This was determined from a copy of the security agreement contained in the court file. A copy of the security agreement was sent to Professor Leary by the Clerk of Court.
\textsuperscript{86} The security agreement between Twist Cap, Inc., (debtor) and the Southeast Bank (Bank) was entered into on March 28, 1978. On December 5, 1977, and June 14, 1978, the Bank issued two letters of credit, each in the amount of $30,000 for the debtor's account, and payable to the defendant/supplier Aluminum Company of America (Alcoa). On March 29, 1979, the Bank issued a letter of credit in the amount
A letter of credit could be analogized, as soon as it is established as to the account party, as an irrevocable commitment by the bank to make a future advance to a third party, made when the bank was already a secured inventory financier. Even if the court were to adopt a "relationship test" as to future advances, the test would be passed because the advances were for the purchase of additional inventory. The advance need not be made until demanded by one of the named creditors. Under the U.C.C., future advances made pursuant to a commitment under a perfected security interest take priority from the date of the first advance, if made before the contending claimant becomes a lien creditor. As to the set-aside provisions of the Bankruptcy Code, the trustee should fare no better. The lien creditor powers are taken from the U.C.C. and from other state law creating liens. When the debt is incurred after collateral is transferred, one must still locate the antecedent debt. The debt of the debtor is incurred when goods are shipped, and at that time, the creditors, having the letter of credit in their possession, are secured.

A different question arose when a letter of credit was established as to the beneficiary after the beneficiary's debt to the account party was incurred. In In re Air Conditioning, Inc., Judge Nesbitt, of the United States District Court for the Southern District of Florida, decided the appeal of Leasing Services Corporation, the beneficiary under a standby letter of credit. Judge Nesbitt saw a conflict between the independence principle and the Bankruptcy Code where the letter was issued after the debt was incurred. The solution was to let the letter of credit of $25,000, payable to the defendant/supplier Central Can Company. It was not until August 22, 1979, that Twist Cap, Inc. filed a Chapter 11 petition in bankruptcy. 1 Bankr. at 285.


As scholars in this area have observed: "[f]uture advance clauses [see U.C.C. § 9-204(3)] must be drafted carefully, however, since courts will strike them down for a variety of reasons, including lack of similarity between the primary obligation and the future obligations covered by the future advances clause." T. THANH TRAI LE & E. MURPHY, SALES AND CREDIT TRANSACTIONS HANDBOOK § 8.25 (1985 & Supp. 1986) (citing Dalton v. First Nat'l Bank, 712 S.W.2d 954 (Ky. Ct. App. 1986) and John Miller Supply Co. v. Western State Bank, 55 Wis. 2d 385, 199 N.W.2d 161 (1972)).

87 U.C.C. § 9-312(7) (added by the 1972 amendments).
88 U.C.C. § 9-312(7) (added by the 1972 amendments).
credit stand, to let the bank keep its security, and to let the trustee in bankruptcy recover the payment from the beneficiary as a voidable preference. The bankruptcy judge had treated the entire deal as a simultaneous transaction, and on the petition of the bank, nullified the letter of credit and ordered the security returned to the trustee in bankruptcy. The same result is reached under both solutions.\footnote{90}

Several other cases have declined to follow \textit{Twist Cap}.\footnote{91} Judge Paskay himself has subsequently confined \textit{Twist Cap}'s effect to the particular circumstances of that case.\footnote{92} \textit{Twist Cap} will apparently languish until someone administers the \textit{coup de grace} efficiently. If that is the situation, then Judge Paskay's subsequent case, \textit{In re St. Petersburg Hotel Assocs.},\footnote{93} stands for the proposition that an outstanding letter of credit pledged as security for the personal guaranty of the account party's general partner is not the property of the partnership estate. In \textit{St. Petersburg}, Judge Paskay refused an injunction, stating,

there is nothing in this record which would warrant either a finding that this particular letter of credit is property of the estate, therefore, protected by the automatic stay or that Royal Trust [the beneficiary] should not be permitted to proceed and obtain the proceeds on the ground that they would

\footnote{90} It is not clear whether the lease had been terminated, or whether, unnoticed by both judges, there were a post-issuance debt for rent which would not have been an antecedent debt.


Finally, as one of the draftsmen of the Bankruptcy Code, Senator Dennis DeConcini, stated in Congress, "[c]ontrary to the language in the case of \textit{Twist Cap, Inc. v. Southeast Bank of Tampa}, payments of the commercial paper by the letter of credit bank . . . are not preferential or enjoinable since the payments are not being made with the property of the estate." 126 CONG. REC. 31,139, 31,153 (1980) (citation omitted).

\footnote{92} \textit{See In re} St. Petersburg Hotel Assocs., 37 Bankr. 380 (M.D. Fla. 1984).

\footnote{93} \textit{Id.}
materially impact Associates.94

Judge Paskay referred to the particular circumstances in Twist Cap as distinguishing factors, thus leaving open something of a threat for another Twist Cap,95 but these circumstances were neither articulated nor even adumbrated in his most recent opinion. What were they? In Twist Cap, Judge Paskay only wrote: "These conclusions should not be construed to be a determination of the debtor’s ultimate right to stop payment of these letters of credit, but pending such determination, it is imperative to preserve the status quo."96

Twist Cap may now mean no more than that the estate may have a preliminary injunction on a Friday afternoon until a determination is made whether particular collateral securing the credit has been transferred "for or on account of an antecedent debt."97

Had Judge Paskay believed that the draw against the letter did not affect the estate in St. Petersburg;98 since there was no collateral "of the debtor" supporting the credit, he undoubtedly would have said so. The conclusion here rests on the fact that the judge in Twist Cap did distinguish an earlier Ninth Circuit decision because that earlier decision involved letters of credit for debts that were not antecedent secured by properties of the bankrupt. Many cases decided after Twist Cap and cited in St. Petersburg did, however, involve similar debts, a consideration not highlighted in St. Petersburg.99

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94 Id. at 383.
95 Id. at 382. The reference by Judge Paskay stated:
This Court had the occasion to consider this question, albeit in a totally different context and held in the case of In Re Twist Cap, Inc., . . . that under the particular state of circumstances involving that case it was proper to issue a temporary restraining order prohibiting the holder of a letter of credit to demand the issuer to honor the same. This decision . . . has been severely criticized and several decisions since expressly rejected the holding without considering the facts involved in that case and the circumstances which this Court considered to be controlling.

Id. (citation omitted). Professor White concludes from this that, "While Judge Paskay seems to join the rest of the crowd, he still leaves open the threat for another Twist Cap decision should he be presented a 'particular state of circumstances.' Perhaps it is the state of confusion." White, Insolvency of Parties to Letters of Credit Transactions, in ALI-ABA Course of Study: Letters of Credit 271-72 (1986).
97 In re St. Petersburg Hotel Assocs., 37 Bankr. 380 (M.D. Fla. 1984).
98 In St. Petersburg, the letter of credit was issued in favor of Royal Trust Bank of St. Petersburg (Royal Trust), a creditor of St. Petersburg Hotel Associates, Ltd., (Associates), the debtor partnership. The letter of credit was pledged as security for a personal guarantee given to Royal Trust by Darrell and Lou Ann Wild. Although both of the Wilds were non-debtors, Mr. Wild was a general partner of Associates. The debtor partnership sought injunctive relief to prevent Royal Trust from proceeding against Mr. Wild on his guarantee secured by the letter of credit. The court held that
LETTERS OF CREDIT

The 365-year-old advice that no one should issue letters of credit unless the issuer "bee well advised before hee doe make them" is again on point. Letters issued within ninety days of bankruptcy filing could be subject to an attack as a preference if issued to support an antecedent debt, and if collateralized in that period by the debtor's assets. Also, while the draw may not be enjoined simply because it neither was made nor ripened before bankruptcy, the issuer's resort to the debtor's collateral is subject to all the bankruptcy rules governing any secured party's resort to the collateral. Nevertheless, the issuer whose letter is to support a debt incurred simultaneously with or subsequent to the issuance should be protected from a decision stating that its payment was a preference, since value was given to the debtor by the issuer when the letter was issued by incurring a binding liability to a third party, and the obligation to pay was not incurred for an antecedent debt.

3.3. Issuing Bank Insolvency

3.3.1. The Philadelphia Gear Shock

Twist Cap itself was a great shock to the law of letters of credit.

Royal Trust could proceed against Mrs. Wild on the personal guarantee, although Mr. Wild, as general partner, was entitled to some injunctive protection. 37 Bankr. at 383. It is significant that Judge Paskay did not refer to the difference between future debts incurred after the issue of the letter of credit, and the issue of a letter of credit to secure antecedent debts incurred before issuance.

This is the exact point of In re Air Conditioning, Inc., 72 Bankr. 657 (S.D. Fla. 1987). The Bankruptcy Judge nullified the letter of credit, cancelled the promissory note and ordered return of the debtor's certificate of deposit securing the issuing bank's reimbursement claim. 55 Bankr. 157 (S.D. Fla. 1985). This was reversed by the District Judge, who stated that the importance of the "independence principle" required allowing the draw to be made and permitting the bank to keep its security, which was given six days after the issuance of the letter of credit, pursuant to the preissuance agreement. The District Judge remanded, indicating that the debtor's trustee could recover from the beneficiary under section 550(a) of the Bankruptcy Code (11 U.S.C.A. § 550(a) (West 1979 & Supp. 1987)) as "the entity for whose benefit the transfer was made." Since the beneficiary's debt arose out of a lease, rentals becoming due after "the transfer" would not be antecedent debts. As the bankruptcy filing date was one month and ten days after the issuance of the letter of credit, only one month's rental out of a total debt of $47,000 was antecedent debt. The letter of credit was for $20,000, and the lessee did not execute under a writ of replevin obtained 92 days before the filing in bankruptcy.Erroneously, the court dismissed what could have been a claim for new value in three monthly rentals, stating in a footnote that "simple forbearance from repossessing goods does not constitute new value." 72 Bankr. at 662 n.4 (citations omitted). Here, the court overlooks the difference between refraining to repossess in collecting an existing debt, and the rental use value of leased property for a period after dropping the replevin proceeding. There is a difference between leases and installment payments on a debt.

Where a letter is being issued to secure a debt already created, the issuer's only protection is to be sure that the account party has enough financing to avoid filing for 90 days.
The municipal bond market and issuers of standby credits suffered an even greater shock — especially as to letters of credit used to enhance the credit of municipal debt instruments believed to be income tax free — when Philadelphia Gear Corp. v. F.D.I.C.\(^{101}\) was decided in 1982 by the United States District Court for the Western District of Oklahoma.\(^{102}\) That case and several similar cases,\(^{103}\) ruled that standby letters of credit gave rise to insured deposits under the insurance provisions of the Federal Deposit Insurance Act, as amended in 1950 and 1960.\(^{104}\) If the ruling stood, municipal bonds worth hundreds of millions of dollars, supported by letters of credit issued by insured banks, stood to lose their tax-exempt status.\(^{105}\) Likewise, the banking industry became potentially liable for an assessment for back premiums, possibly worth several million dollars.\(^{106}\) A petition for certiorari in the Philadelphia Gear, 587 F. Supp. 294 (W.D. Okla. 1982), aff'd in part, rev'd in part, 751 F.2d 1131 (10th Cir. 1984), rev'd 476 U.S. 426 (1986).

The term "deposit" means —

(1) the unpaid balance of money or its equivalent received or held by a bank in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial . . . account, or which is evidenced by . . . a letter of credit or a traveler's check on which the bank is primarily liable: Provided, That, without limiting the generality of the term "money or its equivalent, any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable . . . ."


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106 The liability would stem from the F.D.I.C.'s potential requirement, to insure approximately $120 billion worth of outstanding standby letters of credit. The result would be that the banks would be compelled to pay as much as $100 million for the F.D.I.C. assessment based on then existing deposit liabilities. See Kozolchyk, Is Present Letter of Credit Law Up to Its Task?, 8 GEO. MASON U.L. REV. 285, 306, n.44 (1986). See also McLaughlin, Letters of Credit and FDIC Insurance, 193 N.Y.L.J. 1 (Apr. 12, 1985).

It is noteworthy that no deposit insurance premiums had been collected by the F.D.I.C. on the face amount of outstanding letters of credit as deposits. See infra text.
Philadelphia Gear case was promptly filed and granted. On May 27, 1986, a 6-3 decision of the United States Supreme Court reversed the Tenth Circuit.

About a century ago, Peter Finley Dunne, writing as Mr. Dooley, stated, "No matter whether th' constitution follows th' flag or not, th' supreme court follows th' election returns." It would seem that "th' supreme court" is also sensitive to economic returns: it has ruled that a standby credit secured by a promissory note was conditioned upon a draw by reason of an oral agreement between the account party and issuing bank (which the Court ruled to be governed by federal law and, therefore, the conditional note was not a promissory note as defined in the Federal Deposit Insurance Act). Hence, the note did not create an insured deposit. This sleight of hand appears to erase the shock of the opinion; but, as is the trouble with most result-oriented opinions, it may raise more problems than it resolves.

For years, the F.D.I.C. had not considered commercial letters of credit subject to deposit insurance premiums even when supported by a negotiable promissory note, and had treated standby credits in the same manner. One basis for this position with regard to standby credits was that, when the F.D.I.C. issued its regulations in 1935, standby credits were rarely in evidence; when they first began to be used in any quantity, the general expectation was that drawings thereunder would be scarce. Further, the original definition of deposit referred to:

> the unpaid balance of money or its equivalent received by a bank in the usual course of business . . . which is evidenced by its certificate of deposit . . . together with such other obligations of a bank as the board of directors [of the F.D.I.C.] shall find and shall prescribe by its regulations to be deposit

accompanying note 114.

107 Philadelphia Gear, 751 F.2d 1131 (10th Cir. 1984), cert. granted, 474 U.S. 918 (1985).


110 Standby letters of credit are issued with the expectation that the account party will perform, and hence, there will be no draw. Banks usually charge one percent or less of face value for standby letters of credit compared to two percent or higher for surety bonds. See Letter from Professor Dan Murray to Senator William Proxmire (June 7, 1976), reprinted in Regulation of Standby Letters of Credit: Hearings Before the Comm. on Banking, Housing and Urban Affairs on S. 2347, 94th Cong., 2d Sess. 147-48 (1976). For most banks, the insurance industry's "law of large numbers" is not applicable, and for bank standby letters, there is no reinsurance market.
liabilities by general usage . . . . 111

Shortly after the creation of the F.D.I.C., bank officials met with F.D.I.C. personnel. In response to a question at that meeting regarding the status of letters of credit from a banker, an F.D.I.C. official replied:

If your letter of credit is issued by a charge against a depositor’s account or for cash and the letter of credit is reflected on your books as a liability, you do have a deposit liability. If, on the other hand, you merely extend a line of credit to your customer, you will only show a contingent liability on your books.112

A regulation was issued, and the regulatory language was later expressly incorporated into the statutory language by congressional amendment.113 The Philadelphia Gear opinion also referred without objection to the F.D.I.C.’s contention that it had never charged deposit insurance premiums on standby letters of credit.114

The Philadelphia Gear reversal was based upon the reasoning that the F.D.I.C.’s interpretation had been continuous and consistent, and that legislation passed by Congress in 1960 had expressly adopted the language of the regulation.115 The Court stated that the regulation was also consistent with the congressional purpose, and that it “may certainly stand,” even though the regulation did not state that it was based on that congressional purpose.116 In the process, the Court ruled

113 The specific regulation was 12 C.F.R. § 301.1(d) (1939), revoked after incorporation into statutory law, 12 C.F.R. § 234 (Supp. 1962). The Supreme Court noted: [T]he current statutory definition of “deposit,” added by Congress in 1960, was expressly designed to incorporate the FDIC’s rules and regulations on “deposits.” As Committees of both Houses of Congress explained the amendments: “The amended definition would include the present statutory definition of deposits, and the definition of deposits in the rules and regulations of the Federal Deposit Insurance Corporation, [along] with . . . changes [in sections other than what is now § 1813(l)(1)].” H.R.Rep. No. 1827, 86th Cong., 2d Sess., 5 (1960).
114 See Philadelphia Gear, 106 S. Ct. at 1938. The F.D.I.C. further contended that it had not charged premiums on any other letters of credit, but the case only affected standby credits.
115 We point out, however, that nothing in the record indicates that Congress had any “congressional purpose” except such as was behind the adoption of the F.D.I.C.’s regulation, enunciated long after the original adoption of the concept of deposit
that the note in *Philadelphia Gear* was not a promissory note for purposes of federal law because, pursuant to an oral agreement between the bank and the account party, it was understood that nothing would be considered due on the note and no interest would be charged by the bank until there had been a draw under the letter of credit, despite the fact that the note was unconditional on its face.\textsuperscript{117}

The Court placed much emphasis on the intention of Congress to protect "hard earnings" entrusted to banks,\textsuperscript{118} but drew no lines to show why a commercial letter of credit backed by an unconditional promissory note would differ from a similarly backed standby letter of credit.\textsuperscript{119}

Nor, for that matter, did the dissenting opinion draw any such insurance.

\textsuperscript{117} It is correct that, as between immediate parties, an oral condition precedent to effectiveness may be shown absent a clear indication that the note represented a fully integrated agreement. See 32A C.J.S. *Evidence* § 935 (1952 & Supp. 1986). But is the FDIC an "immediate" party?

We are not unmindful of the rule that parol evidence is inadmissible to attach conditions to a negotiable instrument which is absolute on its face. See 32A C.J.S. *Evidence* § 937 (1952 & Supp. 1986); See also 3 S. Gard, *Jones on Evidence* § 16:59 (6th ed. 1972) ("Accordingly, it is the universally accepted rule that such an instrument [bills and notes] may not be contradicted or varied by parol evidence . . ." (citing, e.g., Brown v. Spofford, 95 U.S. 474, 480 (1877). See generally, 12 Am. Jur. 2d *Bills & Notes* §§ 1241-95 (1970 & Supp. 1986).

It is our contention that the Court failed to distinguish between an oral condition precedent regarding delivery of an unconditional promissory note, and an oral condition on the promise itself, which would impermissably render the obligations of the note conditional. It is the universal rule that a written document, unconditional on its face and fully executed, can be shown by parol evidence as between immediate parties to have been delivered subject to a condition precedent. The conditional delivery of the promissory note may have altered the legal relationship of the parties in *Philadelphia Gear*. But the majority's discussion of the unconditional nature of the note involved did not take into account the usual rule that such conditions are not enforceable against a bank liquidator.

\textsuperscript{118} The majority opinion made continued reference to preserving "hard earnings" or "hard assets," See, e.g., 106 S. Ct. at 1934-37. It is not easy to understand how "hard earnings," especially those of individuals, have anything to do with the problem of letters of credit and promissory notes.

\textsuperscript{119} The same obligation of no interest and no payment until a draw applies to promissory notes unconditional on their face given to back up or secure commercial letters of credit. The difference is that under a standby letter of credit, the makers' and issuing banks' expectation at the time of delivery is that there will never be a draw. See, e.g., B. McCullough, *Letters of Credit: Concepts and Classifications*, in Prac. L. Inst., *Banking Problems Under the U.C.C.* 147 (1982) ("Under a standby letter of credit, the issuer engages to honor the draft on demand for payment by the beneficiary upon a failure of performance of the underlying transaction."). In the case of commercial letters of credit, the expected event is a draw in a short time. Most bankers, the authors have been told, use the unconditional on its face note only for commercial letters of credit and a conditional note for standbys. The practice at Penn Square Bank apparently differed. This practice was the basis for the F.D.I.C.'s argument that a note subject to oral conditions was not to be considered a "money equivalent" for deposit insurance purposes.
line. Indeed, on the track taken by the dissent, such a distinction was not necessary. They saw the matter simply as one of construction. When the statute used the word “promissory note,” it was construed in its commercial sense under commercial law, and was, therefore, the equivalent of money.120 The reasoning was that had the note been negotiated to a third party for value, the agreement between the account party and the issuing bank would not apply to a holder in due course. The conclusion was then drawn that the promissory note could, at the whim of the bank, be transformed into money and was, therefore, the equivalent of money. Thus, to the dissent, the face amount of all letters of credit were insured deposits from the day of issuance.

Neither opinion intimated that the justices were aware that promissory notes hardly ever circulate, or that they are no longer accepted as the equivalent of money. Nor does the majority opinion provide any guideline as to what would happen if, in a commercial letter of credit, both the bank and the account party “understood that nothing would be considered due on the note and no interest charged by [the issuing bank] unless [the beneficiary] presented drafts on the note.”121 Since this may occur in many cases, the F.D.I.C. may have won the battle for all letters of credit. The Court did say that a note such as was involved in the case “was not a promissory note for purposes of the federal law set forth in 12 U.S.C. § 1813(l)(1).”122 However, the majority’s conclusion shifts its focus from the “note” to a combination of the history of administrative practices and the contingency of the note quite early in the opinion. The majority stated, “[w]hen we weigh all these factors together, we are constrained to conclude that the term ‘deposit’ does not include a standby letter of credit backed by a contingent promissory

120 The dissent, too, was on an all-or-nothing track, but their reasoning could be used to draw a distinction between the letters of credit supported by facially unconditional promissory notes and those supported by notes facially conditioned. See 106 S. Ct. at 1939-41. This would eliminate most standbys from deposit coverage, and would remove the cloud over the municipal bond market as to the tax-exempt nature of interest on mutual bonds supported by a standby letter of credit. Their reasoning would, however, create a problem for commercial letters of credit.

121 Id. at 1933.

122 Id. at 1934. The “federal purpose” approach may go too far. Standard commercial terms in a federal statute should not have special federal meanings unless there is a strong need to protect a federal interest, as in the case of forgery of federal checks and state laws expanding issuer liability. The Court was, however, between an irresistible force and an immovable object. The Court failed to take into consideration the possible interpretation that only when the credit was considered fully paid for by the promissory note would the credit be considered an insured deposit. Otherwise, if the note merely evidenced the account party’s obligation to reimburse the issuer or was security for that payment, it was not within the statutory phrase of “in exchange for the letter of credit.”
LETTERS OF CREDIT

note.”

Although, the balance of the opinion seems based entirely on the F.D.I.C.’s interpretation excluding letters of credit and the 1960 Congressional verbatim adoption of the regulation (which, admittedly, does not expressly exclude a standby letter of credit backed by a contingent promissory note) the opinion does not mention the existence of any pre-1960 discussion or non-application of the regulation to standby letters of credit. Nor is there mention of any such data being brought to the attention of Congress in the course of the adoption of the 1960 amendments.

The essential differences between standby letters of credit and commercial letters are: (1) the latter are almost always drawn upon, but the former hardly ever; (2) the time between issue and drawing is usually longer in the case of standby letters of credit; and (3) the use of promissory notes that are facially contingent is very prevalent in standby letters of credit, and at present, rare in commercial letters of credit. None of these differences are highlighted in the statute or the Supreme Court’s Philadelphia Gear opinion.

Indeed, a verbatim construction of the statute would also exclude a number of both standby and commercial letters of credit from the definition of deposit. Streamlined for our purposes, the statute provides:

The term deposit means (1) the unpaid balance of money or its equivalent received or held by a bank in the usual course of business . . . which is evidenced by . . . a letter of credit . . . on which the bank is primarily liable: Provided, that, . . . any such instrument must be regarded as evidencing the receipt of the equivalent of money when . . . issued in exchange for . . . a promissory note upon which the person obtaining such . . . instrument is primarily or secondarily liable.

The key phrase here is “issued in exchange for.” It is significant that both the majority and the minority in Philadelphia Gear did not emphasize or discuss “issued in exchange for,” but referred instead to a “standby letter of credit backed by.” Is there a difference? It is probable that when the wording was drafted by the F.D.I.C., the drafters were thinking of the letter of credit fully funded by a charge to an account, to cash, or to a promissory note taken by the bank as payment for funding. The reference to an account party who may be “seconda-

123 Id. at 1935.
125 See 106 S. Ct. at 1932 (majority’s reference); id. at 1939 (dissent’s reference) (emphasis added).
"Rily liable" seems to indicate a note of a third person taken as payment. If so, then it is clearer that any contingent promissory note, taken as security to evidence the obligation to reimburse the bank for its payment of a draft by the beneficiary, is not included. This reasoning is consistent with the approach taken by an F.D.I.C official at an earlier hearing, a transcript of which appeared in a 1955 case. It is also consistent with section 3-802(1) of the U.C.C. This section governs instruments "taken for an obligation," language very similar to the "issued in exchange for" language. This approach would require the inclusion of both commercial as well as standby letters of credit when the note is taken in satisfaction or substitution of the obligation of the account party to reimburse the issuer, and it would exclude both standby and commercial letters of credit where the note is taken as security and is not treated as a cash equivalent. Hence, deposit insurance obligations would only attach where the note, for letter of credit purposes, was given in lieu of a deposit securing the account party's obligation to reimburse and in satisfaction of the reimbursement obligation.

How then, should the Supreme Court's majority opinion in *Philadelphia Gear* be taken? It seems that the many references in the opinion to the congressional desire to create the F.D.I.C. to protect "hard earnings" and "hard assets" are not very helpful, since, as between the immediate parties, a promissory note is not a hard asset, and is more than the statutory obligation for immediate reimbursement in U.C.C. § 5-114(3).

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127 U.C.C. § 3-802, Effect of Instrument on Obligation for Which It Is Given, states:

(1) Unless otherwise agreed where an instrument is taken for an underlying obligation
   (a) the obligation is pro tanto discharged if a bank is drawer, maker or acceptor of the instrument and there is no recourse to the instrument against the underlying obligor; and
   (b) in any other case the obligation is suspended pro tanto until the instrument is due or if it is payable on demand until its presentment. If the instrument is dishonored action may be maintained on either the instrument or the obligation; discharge of the underlying obligor on the instrument also discharges him on the obligation.

(2) The taking in good faith of a check which is not postdated does not of itself so extend the time on the original obligation as to discharge a surety.

128 U.C.C. § 5-114(3) states:

Unless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than the day before maturity of any acceptance made under the credit.

As between the maker and the payee (who deal with each other), no defenses are cut
We suggest that one somewhat unique aspect of Philadelphia Gear should produce the desired result. Congress, in the Banking Act of 1935, included in its definition of "deposit" a reference to certificates of deposit and trust funds, but concluded the definition with, "together with such other obligations of a bank as the board of directors [of the F.D.I.C.] shall find and shall prescribe to be deposit liabilities by general usage." Less than two months later, the F.D.I.C. in Rule 1 of October 1, 1935, issued a regulation which, among other things, stated that "letters of credit must be regarded as issued for the equivalent of money when issued in exchange for . . . promissory notes upon which the person procuring [the letter of credit] is primarily or secondarily liable." In 1960, Congress included this language in the statute, and in 1962, the 1935 rule was repealed as "revoked after incorporation into statutory law." Since that time, and possibly before, the F.D.I.C. and general banking usage have treated the language as not covering commercial or standby letters of credit. Hence, by limiting the reference to letters of credit to the type of letter covered by contemporary and subsequent administrative practice, any insured deposit status should apply only to commercial letters of credit.

We can thus summarize the Philadelphia Gear holding as follows: When Congress delegates to an administrative agency the right and power to prescribe by regulation additional obligations to be included within a statutory definition, and later includes the regulation within a revised statutory definition verbatim, the language includes only what the regulation was construed to include, and excludes what was excluded by the regulators, regardless of whether the exclusion occurs before or after the statutory incorporation. In such a case, the regulatory construction, if consistent with general industry usage, must be followed by the courts. Consequently, a letter of credit accompanied by a contingent promissory note as security for reimbursement does not

off. See U.C.C. § 3-306, Rights of One Not a Holder in Due Course.

120 12 C.F.R. § 301.1(d) (1939) (codifying Regulation I, Rule 1, Oct. 1, 1935).
121 12 C.F.R. § 301.1(d) (1939) (revoked after incorporation into statutory law, 12 C.F.R. 234 (Supp. 1962)).
create a federally insured deposit, regardless of whether it is facially or orally contingent as between issuer and account party. In this regard, any distinction between standby letters of credit and commercial letters of credit will not withstand analysis. It then follows that letters of credit have survived the initial shock of the Philadelphia Gear case.

3.3.2. Provability Rules

Less drastic in impact are the "provability" rules applied where the issuer is insolvent. The courts have not followed the F.D.I.C.'s position that by the time the bank is closed, if the beneficiary has not made a claim on a standby letter of credit, then that credit will not be considered in the insolvency of the issuer.

Where the claims under standby letters of credit have ripened before insolvency, and presentation has been made before a cut-off date for filing claims or before the first distribution to claimants, courts have required their inclusion. Various questions might, however, arise

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132 Generally, the beneficiaries of a letter of credit issued by an insolvent bank are limited to the recovery of only "provable claims." See White, Insolvency of Parties to Letter of Credit Transactions, in ALI-ABA COURSE OF STUDY: LETTERS OF CREDIT 278 (1986). These claims will be grouped with other general claimants absent priority, either by way of "secured deposits" or through U.C.C. § 5-117. Id. Generally, three conditions must be met for claims under a credit to be provable: (1) the claim must be in existence prior to insolvency; (2) the total liability must be certain when the beneficiaries sue the receiver; and (3) the claims must be timely made prior to the distribution of assets from the receivership estate. See Philadelphia Gear Corp. v. F.D.I.C., 751 F.2d 1131, 1138 (10th Cir. 1984). Claims which are uncertain at the time of the issuers insolvency, but become certain and are filed prior to distribution of the receivership assets are deemed provable, and should be permitted to participate in ratable dividends. See First Empire Bank v. F.D.I.C., 572 F.2d 1361 (9th Cir.), cert. denied, 439 U.S. 919 (1978). For further coverage of the provability rules and issuer insolvency, see J. DOLAN, supra note 6, at ¶ 12.02; Berger, The Effects of Issuing Bank Insolvency on Letters of Credit, 21 HARV. INT'L L.J. 161 (1980); Verkuil, Bank Solvency and Standby Letters of Credit: Lessons From the USNB Failure, 53 TUL. L. REV. 314 (1979); Verkuil, Bank Solvency and Guaranty Letters of Credit, 25 STAN. L. REV. 716 (1973).

133 See First Empire Bank v. F.D.I.C., 572 F.2d 1361 (9th Cir. 1978); see also First Empire Bank-New York v. F.D.I.C., 634 F.2d 1222 (9th Cir. 1980), cert. denied, 452 U.S. 906 (1981) (a connected case in which the court clarifies to some degree its earlier holding); Philadelphia Gear, 751 F.2d 1131 (10th Cir. 1984); In re F & T Contractors, Inc., 718 F.2d 171 (6th Cir. 1983) (holding that while the F.D.I.C. corporation was not liable for the wrongful termination of a standby credit, the F.D.I.C. receiver was liable as it had assumed the contingent liabilities of the issuer); International Westminster Bank, Ltd. v. F.D.I.C., 509 F.2d 641 (9th Cir. 1975) (holding that credit beneficiaries could state a claim for relief under the National Bank Act, 12 U.S.C. §§ 91, 194); F.D.I.C. v. Freudenfield, 492 F. Supp. 763 (E.D. Wis. 1980) (although court does not address the F.D.I.C.'s position, it does assess the facts of the beneficiary's claim against the F.D.I.C. and the court's judgment in favor of the beneficiary on the strength of First Empire).

134 See, e.g., First Empire Bank, 572 F.2d 1361 (9th Cir. 1978).
where the right to draw has not ripened in a standby credit. The following situations demonstrate these questions:

Case 1: Both account party and beneficiary are solvent and have good credit. A substitute letter can be obtained, but at a greater cost. Is there a provable claim for the added cost?\textsuperscript{138}

Case 2: Both account party and beneficiary are solvent, but the account party's credit status has worsened. A substitute letter of credit cannot be obtained. Does either the beneficiary or the account party have any provable claim against the insolvent issuer? For what?

Case 3: The account party is also insolvent and its insolvency representative rejects the wholly executory underlying contract. Does the beneficiary have any claim against the insolvent issuing bank?\textsuperscript{138}

Case 4: The beneficiary is also insolvent and its insolvency representative rejects the underlying contract. The issuing bank may or may not be insolvent.

Absent relevant case law, claims under Cases 1 and 2 should be considered provable. The lag between the closing of the bank and the computation of a distribution should be sufficient to develop the facts needed in time to file the claims. In Case 1, the claim is for an antici-

\textsuperscript{138} The F.D.I.C. apparently takes the position that a substitute letter should be obtained by routinely denying liability on outstanding letters of credit where no draw has been made. As a result of the \textit{Philadelphia Gear} litigation, the denial will probably only apply to unripened claims. Obtaining a substitute would, however, ostensibly be an account party's mitigation of damages under the underlying contract, and on the contract created by the application. Here the bank has, in effect, repudiated its contract with the account party, and thereby caused the account party to incur extra expense, to the extent of paying an additional fee, which might well be greater than the original unrefunded fee. The account party will be the claimant here. Yet, Article 5 provides no remedy to an account party aggrieved by the repudiation of the letter by the issuer. It seems that the general principle of placing an aggrieved party in the position it would have realized had performance occurred should permit recovery of the additional cost. This argument follows by analogy to a buyer's "cover" damages under U.C.C. § 2-712, since an account party's claim is not on the letter of credit.

\textsuperscript{138} Here, in essence, we have a double repudiation. Again, in the case of the standby letters of credit, the draw is usually based on the provision in the contract, a contract now rejected by the account party, requiring the payment in the event of a failure to perform. \textit{See supra} discussion of standby letters of credit at note 43. The insolvency provision for rejection of executory contracts does not destroy a right to damages for anticipatory repudiation. \textit{See 2 A. Squillante & J. Fonseca, The Law of Modern Commercial Practices} § 7:30 (rev. ed. 1980 & Supp. 1986). In the case of national banks, the claim against an issuing bank would be subject to the ripening rules. \textit{See supra} notes 133-34. Thus, there may be a question of timing. In this discussion, if the insolveney of the account party and the rejection of the contract occurred before the insolvency of the bank, the claim would be ripe and could be timely filed. The reverse order of occurrence of the insolvencies could leave the beneficiary with a claim too contingent to assert against the issuing bank, but its contract claim against the account party will still be maintainable.

\textsuperscript{138} In this case, we have three insolvencies and, insofar as the issuing bank is concerned, there should be no liability, despite the independence principle.
patory breach of contract. In Case 2, the account party’s claim is the same; but the measure of damages may be quite different. In either case, a duty to mitigate damages would require good faith efforts to obtain a substitute credit. The added cost is the damage in Case 1.

The court in *Bryant v. Kerr* dismissed a claim, based on a standard F.D.I.C. repudiation letter, for anticipatory repudiation on the grounds that the beneficiary had not proven it was ready, able and willing to perform by drawing because the account party’s performance was not yet due. The court went further, however, and held that a clause requiring a letter of credit to be “maintained in full force and effect” had not been breached by the issuing bank’s insolvency. This seems to be an incorrect approach. A claim against an insolvent bank is worth considerably less than a claim against a solvent bank. Obviously, the court was disturbed by the beneficiary’s rush to the cancellation clause without giving the account party time to tender a substitute letter from a solvent bank. In fact, the account party had tendered a substitute letter after receipt of the termination notice on the original letter.

In Case 2, the account party’s damage would depend on whether the failure to maintain a letter of credit constitutes a default in the underlying contract, thereby triggering the right to the damages protected by the letter of credit. We do not know the answer, but feel that the account party should have little recovery, since it would have had to reimburse the issuing bank had that bank paid a proper draw. If the beneficiary were to cancel the underlying contract for

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188 3 U.C.C. Rep. Serv. 2d (Callaghan) 711 (Mo. Ct. App. 1987). While the terms of Article 5 of the U.C.C. provide no remedy for the account party, and since, under U.C.C. § 1-109, section captions are part of the Code, § 5-115’s caption, “Remedy for Improper Dishonor or Anticipatory Repudiation,” could be taken as exclusive. But this should only apply to the beneficiary under the independence principle, since the account party’s claim is not on the letter of credit, but arises out of the application contract.

139 Generally speaking, a contract to pay via means of a letter of credit should imply an obligation to keep an established credit in force. The letter of credit usually is a condition to the beneficiary’s willingness to deal with the account party concerning the underlying contract.

140 Assuming the account party can meet the burden of proof, and the beneficiary does not cancel the underlying contract, the account party would have no damages. But when we add a cancellation by the beneficiary caused by the issuer’s repudiation of the letter of credit, the account party would have to pay the stipulated liquidated damages in any event, either as reimbursement to the issuing bank, or as direct damages to the beneficiary. But can the account party recover other lost profit damages based on proof that it could have successfully completed the underlying contract, accompanied by the requisite proof of its lost profits? Such evidence will rarely be available to an account party unable to procure a substitute letter, but the situation could occur. Here we again face the problem of no account party remedy in Article 5 of the U.C.C., and the probable characterization of these damages as consequential which “may be had except as specifically provided in this Act or by other rule of law.” U.C.C. § 1-106(1). Here, the
failure to maintain the letter of credit, the account party could ordinarily recover from the issuer for loss of profits on proof of ability to complete the contract without default, had the insolvent issuer assumed the letter of credit instead of rejecting it. Recovery of such damages, however, depends on whether the issuing bank would have any liability for consequential damages. Usually, such damages are excluded by the contract between the account party and the issuing bank. Also, the failure to obtain a substitute letter (a default in Case 2) makes it extremely doubtful that the account party will be able to prove its ability to complete the contract. Cases 3 and 4 are cases of double insolvency. In Case 4, it seems that in commercial letter of credit cases, the bank should have no liability: the double rejecting of the underlying contract in such a case could excuse the bank's performance despite the independence principle.\footnote{141} No transfer has been made on the underlying contract, the receiver of money has not parted with value, and the payor has not received the consideration for which payment was made. Thus, no one has a loss of value.

In the standby letter of credit cases, the insolvent beneficiary's rejection of the underlying contract would be based on the fact that the contract was no longer profitable to complete. In such cases, there should be no recovery against the insolvent bank by the account party or by the beneficiary.

Assuming a standby credit situation in Case 3, however, the default could be the precise default for which the letter of credit was obtained, even if the standby was to ensure the payment of unpaid com-

\footnote{See supra text accompanying note 16.}
mercial invoices. But, where the letter of credit's purpose was to ensure the payment of liquidated damages, the beneficiary should also have a claim against the receiver of the issuing bank for anticipatory repudiation on the part of the issuing bank, with deduction for any recovery obtainable from the account party.\textsuperscript{142}

To the extent necessary to achieve the results indicated above, there should be an exception to the independence principle, and, perhaps some modification of the rules requiring the right to draw to have "ripened" before distribution.\textsuperscript{148} In cases of the insolvency of the issuing bank where the letter of credit has not been prepaid, the essential use of the letter of credit as an instrument to ensure payment in an underlying contract should be recognized. The beneficiary presenting documents should be able to reach the account party's obligation and apply it to pay the full amount to the issuing bank to the extent the bank does not pay the beneficiary.\textsuperscript{144} Where both the issuing bank and the account party are insolvent, the beneficiary should be entitled to dividends from both up to the total amount due upon presentation of conforming documents.\textsuperscript{145}

4. CONCLUSION

Despite the hoary antiquity of the device, letters of credit have survived the three insolvency shocks with youthful vigor. While the conclusions set forth above appear sound, we cannot assume that all courts and commentators will agree with them. What then should be

\textsuperscript{142} The beneficiary cannot recover both. Since any recovery by the beneficiary against the issuing bank would trigger a right in the insolvency representative of that bank to reimbursement from the account party, it seems logical to have the account party the primary source, with the beneficiary filing in both insolvencies. The beneficiary would benefit from any rights to collateral under U.C.C. § 5-117. If there is collateral, that should be the primary source of recovery before the beneficiary files unsecured claims against both the issuing bank and the account party for any deficiency.

\textsuperscript{144} In insolvency situations, the rights of other creditors of the insolvent bank require that, for example, the beneficiary be made as nearly whole as possible by considering the three contracts as one transaction and allocating the beneficiary a recovery source that least harms other creditors. Where the account party and the issuing bank are both insolvent, the acceptability of credits will be enhanced by making some reservation for the beneficiary in a first distribution, which, if the claim did not ripen by the time of the last distribution, could be distributed pro rata to other creditors.

\textsuperscript{145} Of course, to the extent the bank pays, it should have a claim for reimbursement against the account party, subordinate only to the beneficiary's right to receive full payment of the balance due. If the account party is also insolvent, total claims should not be increased. The beneficiary and the bank should have but one claim.

\textsuperscript{146} In all cases discussed, we are assuming that the presented documents are conforming documents under our discussion of the "linguistic equivalency" or "substantive identity" reading of the strict compliance principle.
done?

As to the effect of issuer insolvency and federal deposit insurance, much costly litigation could be avoided by a federal statute that makes the difference between commercial and standby letters of credit in issuer insolvency cases clear beyond argument. The statute could be modeled along the lines of our suggested analysis of the Supreme Court's holding in *Philadelphia Gear* and our suggested solutions discussed above.146

In the case of issuer insolvency with prefunded letters of credit outstanding, the provisions of section 5-117 of the U.C.C. should be made applicable to national banks by federal administrative regulation, if practicable, and if not, by statute.

Supplemental comments to the U.C.C. might effectively indicate to the courts that they should follow the foregoing suggestions regarding the independence principle and the principle of linguistic identity in strict conformity. These comments may not have the force of comments in existence before a legislature adopted the U.C.C. or a second set of amendments where such comments would, in usual course, be made available to the legislators before the final vote. Nevertheless, such supplemental comments should have a far greater force than an article or a treatise because they represent the opinion of the American Law Institute and the National Conference of Commissioners on Uniform State Laws. This suggestion does not result in legislation by comment: the supplemental comment(s) would merely state the substance of the letter of credit transaction as a whole, a transaction embodied in three contracts which are to be treated separately for most, but not all, purposes.

146 See Section 3.3.