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"LETTERS OF CREDIT: THE PERFECT SECURITY OR NOT?"

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INTRODUCTION

A letter of credit is defined as "an engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit." UCC § 5-103(1)(a).[1] A letter of credit is used to facilitate commercial transactions by providing an independent guarantee and assurance of payment to protect the parties. See AmSouth Bank, N.A. v. Martin, 559 So. 2d 1058 (Ala. 1990); Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank of Miss., 571 F.2d 871 (5th Cir. 1978)(applying Mississippi law); Dynamics Corp. of America v. Citizens and S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973). Utilized for centuries in financing the international sale of goods,[2] letters of credit have become useful tools in recent years in securing a variety of obligations, including performance of construction contracts and payment of subcontractors and suppliers. A letter of credit, however, is a unique device which, while similar, is quite distinct from a guaranty or suretyship agreement. Moreover, although a letter of credit can provide a strong measure of security, it has its pitfalls and is by no means perfect.

I. COMPONENTS OF LETTER OF CREDIT TRANSACTION.

A letter of credit involves three parties: (1) An issuer (generally a bank) who agrees to pay conforming drafts presented under the letter of credit; (2) a bank customer or "account party" who orders and induces the bank to issue the letter of credit; and (3) a beneficiary to whom the letter of credit is issued, and who is entitled to draw on the letter of credit by presenting drafts and making proper demand on the issuer. See UCC § 5-103(1); Revised UCC § 5-102. Thus, a letter

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[1] See also Chevron U.S.A., Inc. v. Traillour Oil Co., 987 F.2d 1138 (5th Cir. 1993)(applying Louisiana law); Sun Marine Terminals, Inc. v. Artoc Bank and Trust, Ltd., 797 S.W.2d 7 (Tex. 1990); Citronelle Unit Operators Comm. v. AmSouth Bank, N.A., 536 So. 2d 1387 (Ala. 1988); Chilton Air Cooled Engines, Inc. v. First Citizens Bank of Hohenwald, 726 S.W.2d 526 (Tenn. Ct. App. 1986); Sunset Investments, Ltd. v. Sargent, 52 N.C. App. 284, 278 S.E.2d 558 (1981); Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224 (5th Cir. 1973), cert. dismissed, 414 U.S. 1139 (1974).

[2] The law of letters of credit transaction has been impacted and shaped by codification in Article 5 of the Uniform Commercial Code, which was revamped in 1995, and by the periodic promulgation by the International Chamber of Commerce of Uniform Customs and Practice for Documentary Credits (UPC). As revised, the UCC now recognizes that if the UPC is incorporated by reference into the letter of credit, the agreement varies the provisions of Article 5 with which it conflicts except for the non-variable provisions of Article 5. See Revised UCC § 5-116(c).

of credit is a three-party arrangement involving two contracts and the letter of credit obligation itself. The first contract typically exists between a bank and its customer whereby the bank agrees to issue the letter of credit, and the customer agrees to repay the bank for the amount paid under the letter of credit.[3] Second, there is the underlying contract between the bank's customer and the beneficiary under which the customer owes some obligation to the beneficiary that can be satisfied by payment under the letter of credit. Finally, there is the letter of credit itself, which is the engagement or pledge between the issuing bank and the beneficiary. See, e.g., Resolution Trust Corp. v. United Trust Fund, Inc., 57 F.3d 1025 (11th Cir. 1995)(applying Florida law); Citizens & Peoples Nat'l Bank of Pensacola v. Futch, 650 So. 2d 1008 (Fla. Dist. Ct. App. 1994); Rose Developments, Inc. v. Pearson Properties, Inc., 38 Ark. App. 215, 832 S.W.2d 286 (1992); Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461 (2d Cir. 1970).

A. "Independence principle"

It is fundamental that the letter of credit is separate and independent from the underlying business transaction between the issuer's customer and the beneficiary of the letter of credit. See, e.g., Citronelle Unit Operators, 536 So. 2d at 1390; Union Planters Nat'l Bank v. World Energy Sys. Assocs., 816 F.2d 1092 (6th Cir. 1987)(applying Tennessee law); Fidelity Nat'l Bank of S. Miami v. Dade County, 371 So. 2d 545 (Fla. Dist. Ct. App. 1979); East Girard Sav. Ass'n v. Citizens Nat'l Bank and Trust Co. of Baytown, 593 F.2d 598 (5th Cir. 1979)(applying Texas law); O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 250 S.E.2d 587 (1978). See also UCC § 5-114(1); Revised UCC §§ 5-103(d), 5-108(f); UPC 500 (1993), Art. 3; J. Dolan, supra note 3, ¶¶ 6.01; 4.03[6][a]. Upon presentment of documents conforming to the letter of credit, the issuer must honor drafts drawn by the beneficiary, notwithstanding any dispute between the customer and the beneficiary about the underlying transaction. See Dibrell Bros. Int'l S.A. v. Banca Nazionale Del Lavoro, 38 F.3d 1571 (11th Cir. 1994)(applying Georgia law); Resolution Trust Corp. v. Kimball, 963 F.2d 820, 822 (5th Cir. 1992)(applying Texas law); Sea Management Serv., Ltd. v. Club Sea, Inc., 512 So. 2d 1025 (Fla. Dist. Ct. App. 1987). Thus, the issuer's commitment is not affected by the beneficiary's failure to perform its obligation under the underlying contract or the fact that the customer has a defense or counterclaim against the beneficiary. Id. See also 3 James J. White & Robert S. Summers, Uniform Commercial Code: Practitioner's Treatise Series § 26-5 (4th ed. 1995).[4] Nor is the issuer's payment obligation excused because of the customer's insolvency or bankruptcy. See, e.g., Centrifugal Casting Mach. Co. v. American Bank & Trust Co., 966 F.2d 1348, 1352 (10th Cir. 1992). This independence of the letter of credit from the underlying contract is considered the "key to the uniqueness of a letter of credit and to its commercial vitality." Pringle-Associated Mortgage Corp., 571 F.2d at 874. See also United States v. Sun Bank of

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[3] In the typical case, the bank requires its customer to deposit funds or collateral sufficient to secure the bank's liability to the beneficiary of the letter. J. Dolan, The Law of Letters of Credit: Commercial and Standby Credits ¶ 2.01 (rev. ed. 1996).

[4] The issuing bank is not required or permitted to go behind the terms of the letter and the documents presented, and to enter controversies between the beneficiary and the bank's customer. Bank of the Southeast v. Jackson, 413 So. 2d 1091, 1099 (Ala. 1982). See also Philadelphia Gear Corp. v. Central Bank, 717 F.2d 230, 235 (5th Cir. 1983)(applying Louisiana law); Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802, 805 (4th Cir. 1975)(applying North Carolina law). See also Security Fin. Group v. Northern Ky. Bank and Trust, Inc., 858 F.2d 304, 307 (6th Cir. 1988)(applying Kentucky law)("Emphasis of the underlying arrangements instead of the document itself . . . undermines the security and reliability of the letter of credit by making payment contingent upon relationships unknown to a lender or to a party relying upon it. If the lender may not rely on the strength of the document itself, the letter of credit becomes unreliable and therefore worthless.")

Miami, 609 F.2d 832, 833 (5th Cir. 1980); Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 465 (2d Cir. 1970).[5]

B. Expiration Date

It is important to recognize that a letter of credit usually has a stated expiration date which the courts tend to enforce strictly. This expiration date generally is the date within which the beneficiary must present the documents, as opposed to the date by which the issuer must make payment. See, e.g., Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386 (D. Md. 1982), aff'd, 704 F.2d 136 (4th Cir. 1983)(Court upheld bank's refusal to pay on letter of credit where beneficiary mailed draft before expiration date of letter, but bank did not receive same until after such date). Accordingly, early presentment under the letter of credit, if possible, should occur so there will be sufficient time to correct any nonconforming documents before the letter expires.

C. Rights and remedies of parties

1. The Beneficiary

Most courts hold that the beneficiary must strictly comply with the terms of the letter of credit in order to receive payment. See, e.g., Mobile Oil Corp. v. Atlanta Nat'l Bank, 745 F.Supp. 384 (E.D. Tex. 1990)(whether presentment is proper is a question of law for court to decide); N & C Properties v. AmSouth Bank, N.A., 558 So. 2d 906 (Ala. 1990)(Court upheld summary judgment in favor of bank based on defective presentment under letter of credit); Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 528 F.2d 802, 805-06 (4th Cir. 1975)("[T]he beneficiary must meet the terms of the credit--and precisely--if it is to exact performance of the issuer."); Dynamics Corp., 356 F.Supp at 995. As one Court observed, "[t]his doctrine of strict compliance is firmly grounded in commercial reality" since the issuer will lose its right to reimbursement from its customer if payment is made upon presentations that do not conform to the credit. Philadelphia Gear Corp., 717 F.2d at 236. See also Chase Manhattan Bank v. Equibank, 550 F.2d 882 (3d. Cir. 1977). A smaller number of courts has held that slight variances are not fatal, so long as there is "substantial compliance" with the terms of the letter, and "there is no possibility that the documents submitted could mislead the issuer to its detriment." First Nat'l Bank of Atlanta v. Wynne, 149 Ga. App. 811, 256 S.E.2d 383, 387 (1979). See also Crocker Commercial Servs., Inc. v. Countryside Bank, 538 F.Supp. 1360 (N.D. Ill. 1981)(reasonable compliance); Flagship Cruises, Ltd. v. New England Merchants Nat'l Bank of Boston, 569 F.2d 699 (1st Cir. 1978); Banco Espanol de Credito v. State St. Bank and Trust Co., 385 F.2d 230 (1st Cir. 1967), cert. denied, 390 U.S. 1013 (1968).[6]

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[5] A narrow exception to the "independence principle" arises when there is fraud, forgery or other defect in the documents accompanying the beneficiary's draft, or if there is "fraud in the transaction." See Sztejn v. J. Henry Schroder Banking Corp., 31 N.Y.S.2d 631, 634, 177 Misc. 719 (N.Y.Sup. Ct. 1941)("[T]he principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.") See also note 8, infra.

[6] These differences may soon be academic in many States given the 1995 revisions to the UCC. Under Revised UCC § 5-108(a), strict compliance of the presentation with the letter of credit is now the standard.

The issuer's refusal to pay a complying presentment generally constitutes wrongful dishonor entitling the beneficiary to remedies under UCC § 5-115. Such damages typically are equal to the face amount of the draft or demand, together with incidental damages and interest, less any offset resulting from the beneficiary's duty to mitigate. See East Girard Sav. Ass'n, 593 F.2d at 603 (beneficiary allowed to recover face value of letter of credit even thought it could not prove it suffered damages as a result of the wrongful dishonor). See also J. White & R. Summers, supra, § 26-14.[7]

2. The Issuer

As previously mentioned, the issuer is obligated to pay the beneficiary if the documents required by the letter of credit appear on their face to comply with the terms of the credit.[8] UCC § 5-114(1); Revised UCC § 5-108(a); Republic Nat'l Bank of Miami v. Fidelity and Deposit Co. of Md., 894 F.2d 1255, 1257-58 (11th Cir.), cert. denied, 498 U.S. 926 (1990)(applying Florida law)(bank has no obligation to determine whether documents presented are in fact genuine; rather, the bank's only duty is to examine the documents to determine that they conform to the terms of the letter of credit); Sea Management Serv., Ltd., 512 So. 2d at 1026, citing Fidelity Nat'l Bank v. Dade County, 371 So. 2d 545, 548 (Fla. Dist. Ct. App. 1979)(issuing bank is only required to perform ministerial task of laying the instruments next to one another and determining whether they precisely coincide with those mandated by the letter of credit). Under the UCC, as revised, the issuer has a reasonable time after presentation, but not beyond the end of the seventh business day after receipt of the documents, to determine whether to honor the demand for payment.

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[7] Under Revised Article 5, § 5-111, such damages now may include attorney's fees and expenses in litigation and payment of the full amount of the wrongfully dishonored demand, with interest, without an obligation of the beneficiary to mitigate damages.

Any action under Revised Article 5 must be brought within one year after the expiration date of the relevant letter of credit or one year after the claim for relief or cause of action accrues, whichever occurs later. The accrual date is the date when the breach occurs, regardless of the aggrieved party's lack of knowledge of the breach. See Revised UCC § 5-115. This statute of limitations only applies to letters of credit issued on or after the effective date of Revised Article 5 (no earlier than 1995).

[8] As noted previously, a narrow exception to the issuer's obligation to honor an apparently conforming draft or demand for payment occurs when a required document is, inter alia, forged or fraudulent, or there is "fraud in the transaction." UCC § 5-114(2).

The fraud standard has been changed in the Revised Code. Section 5-109(b) requires that a document be forged or "materially fraudulent" or that honor would facilitate a "material" fraud by the beneficiary against the issuer or the customer.

In instances of forgery or fraud, a customer may seek to enjoin payment of a draft. Revised Article 5 has raised the customer's burden of proof and is intended to limit the use of injunctive relief to egregious circumstances. "These changes to 5-109 rest on the hypothesis that injunctions should be few and far between, that injunctions are injurious to the vitality of the letter of credit, and that the cases in which an injunction is sought far exceed those where an injunction is deserved." J. White & R. Summers, supra, § 26-10.

Revised UCC § 5-108(b) and (c).[9] Upon payment, the issuer is entitled to immediate reimbursement from its customer, see UCC § 5-114(3); Revised UCC § 5-108(i); Braun v. Intercontinental Bank, 466 So. 2d 1130 (Fla. Dist. Ct. App. 1985), unless the issuer wrongfully honored a draft or demand for payment against noncomplying documents. J. White & R. Summers, supra, § 26-11. In such instance, the issuer's remedy is against the beneficiary for breach of warranty. See UCC § 511(1); Revised UCC § 5-110. See also Sun Marine Terminals. Under Revised UCC § 5-115, any such action must now be commenced within one year after the expiration date of the letter of credit or one after the claim for relief or cause of action accrues, whichever occurs later. See note 7, supra.

3. The Customer

The customer generally is obligated to reimburse the issuer upon the issuer's payment under the letter of credit. UCC § 5-114(3). As mentioned above, an exception exists where the bank wrongfully honors a draft or other demand for payment. See J. White & R. Summers, supra, § 26-11. See, e.g., Resolution Trust Corp. v. Kimball, 963 F.2d at 825. Often, however, the issuer will immediately apply collateral or funds deposited by a customer to reimburse itself following payment under the credit. In such instances, the customer may sue the beneficiary on the underlying contract for damages, or alternatively, pursue recovery against the issuer for wrongful honor. J. White & R. Summers, supra, § 26-11. See also In re Eastern Freight Ways, Inc. v. Seaboard Sur. Co., 9 B.R. 653 (S.D. N.Y. 1983). For letters of credit issued after the effective date of UCC Revised Article 5 (in most States, after 1995), the one year limitations period referenced above will apply.

II. TRADITIONAL OR COMMERCIAL V. STANDBY LETTERS OF CREDIT

Since the adoption of the UCC in the 1960's, the letter of credit has become increasingly useful in non-sale settings where it can serve to reduce the risk of nonperformance under a contract. The use of the letter of credit in this capacity is referred to as a "guaranty" or "standby" letter of credit.

Commercial letters of credit differ from standby letters of credit in several respects.[10] First, the beneficiary of a commercial letter of credit may draw upon the letter simply by presenting the requisite documents showing that the beneficiary has performed and is entitled to the funds. A standby letter of credit, on the other hand, requires the production of documents showing the customer has defaulted on its obligations to the beneficiary, which triggers the beneficiary's right to draw down on the letter. See Temtex Products., Inc. v. Capital Bank & Trust Co., 623 F.Supp. 816 (M.D. La. 1985); Republic Nat'l Bank of Dallas v. Northwest Nat'l Bank of Fort Worth, 578 S.W.2d 109 (Tex. 1978). Second, the issuer of a standby letter of credit, as opposed to a commercial letter of credit, usually does not expect the beneficiary to draw on the credit. See J. White & R. Summons, supra, § 26-1. In most cases, a draw on a standby letter of credit indicates

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[9] Under Article 13 of the UPC, as revised in 1993, banks must act within a reasonable time, not to exceed seven (7) banking days following receipt of the documents, to examine the documents and determine whether to honor the demand for payment.

UCC § 5-112(1), instead, required the issuer to honor a letter of credit by the third banking day following receipt of conforming documents.

[10] No distinction, however, is made in the UCC between commercial and standby letters of credit.

the customer is experiencing financial difficulties, is insolvent, or that something has otherwise gone awry. Id. As a result, the issuer of a standby letter of credit faces much greater risk in protecting itself in the event of payment than the issuer of a commercial letter of credit. See J. Dolan, supra note 3, ¶ 1.04.[11]

III. LETTERS OF CREDIT V. SURETY BONDS

Letters of credit can often serve the same purpose as performance and payment bonds, but there are several notable distinctions between the two. Although letters of credit and surety bonds can both be used to ensure against a principal's nonperformance, they function in quite different ways.

The primary distinction between a letter of credit and a surety bond involves the scope of the obligations. Under the letter of credit, the issuer's obligation to the beneficiary is primary. See, e.g., Asociacion De Azucareros De Guatemala v. United States Nat'l Bank of Oregon, 423 F.2d 638 (9th Cir. 1970); Barclays Bank, 481 F.2d at 1236. The issuer is unconcerned with the underlying contract and cannot claim the defenses that the customer may have against the beneficiary. Id. The surety, by contrast, may assert the defenses of its principal and is only secondarily liable following a default. Id. See also J. White & R. Summers, supra, § 26-2.

Because of these fundamental differences, surety bonds are considered more expensive to issue and can be more difficult to obtain than letters of credit. Unlike letters of credit, bonds tend to generate higher costs since a factual determination, rather than an examination of documents, is frequently involved. See, e.g., Republic Nat'l Bank, 578 S.W.2d at 114. See also J. Dolan, supra note 3, ¶ 1.05.

Under a traditional performance bond, when the principal defaults in its performance of the underlying contract, the surety not only sustains losses in completing the principal's performance, but often incurs large costs in simply determining whether the principal has in fact defaulted. Such costs are significantly increased if the surety is forced to litigate the issue of default. Similarly, the obligee can face potential problems in determining whether a principal has defaulted. Typically, the surety may have no duty to act until the obligee has declared the principal to be in default or has otherwise established that the principal failed to perform, a fact the obligee may have to establish in litigation. Until litigation is completed, the obligee often receives no payment, and it may also bear the costs in any delay in completing the bonded project. See also J. Dolan, supra note 3, ¶ 1.05.

The beneficiary of the standby letter of credit, on the other hand, expects to receive prompt payment in the event of nonperformance. Even if the customer has in fact performed and the beneficiary's presentation of documents is wrongful, the beneficiary, rather than the customer, holds the proceeds of a drawn down letter of credit while the parties litigate any differences concerning performance. Thus, while the customer can sue the beneficiary relative to a wrongful draw on the letter of credit, the beneficiary enjoys the use of the money during the litigation period. See Resolution Trust Corp. v. United Trust Fund, 57 F.3d at 1035. In short, since the applicant of a standby letter of credit agrees to a quick and efficient payment mechanism, it cannot expect

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[11] Additionally, because standby credit transactions arise from various types of business ventures, issuers often must acquaint themselves with the nature of the customer's business activity and documents unique to same in order to determine whether to honor demands for payment. As a result, issuers may face increased costs when providing standby letters of credit for customers involved in complex projects. See J. Dolan, supra note 3, ¶ 1.04.

to receive a detailed inquiry into the beneficiary's performance as it would under a performance bond. See also J. Dolan, supra note 3, ¶ 1.05.

Finally, it is important to recognize that the scope of protection afforded under letters of credit and bonds may differ significantly. Payment bonds benefit third parties who perform work or supply materials on a bonded project, while letters of credit specify a particular beneficiary and have strict rules regarding the transfer of money to that beneficiary. See also J. Dolan, supra note 3, ¶ 1.05. If a contractor obtains a standby letter of credit to protect an owner in the event the contractor fails to perform, subcontractors or suppliers who are not paid by the contractor may receive no protection from the letter of credit. Several courts, in fact, have refused to reform letters of credit to provide protection to subcontractors and other non-beneficiaries in very similar situations. See, e.g., Arbest Constr. Co. v. First Nat'l Bank & Trust Co., 777 F.2d 581 (10th Cir. 1985)(Court rejected assertion that subcontractors were third-party beneficiaries of letter of credit and upheld judgment in favor of issuing bank); Cf. Gray & Son, Inc. v. Maryland Deposit Ins. Fund Corp., 83 Md. App. 584, 575 A.2d 1272 (1996)(court denied contractor rights under a letter of credit issued to a county); Seattle-First Nat'l Bank v. Federal Deposit Ins. Corp., 619 F.Supp. 1351 (W.D. Okla. 1985)(ordinarily, beneficiary is only party entitled to demand payment under letter of credit). See also J. Dolan, supra note 3, ¶ 1.05.

CONCLUSION

A letter of credit is a useful but imperfect device. Ideally, the letter of credit provides a quick, efficient and secure means for a beneficiary to receive payment if the terms of the letter are strictly followed. If all goes well, the issuer, upon payment, can recover against its customer under the reimbursement agreement. A litany of problems can occur, however, which may result in time-consuming and potentially complex litigation.[12]

Over the past few years, contractors increasingly have looked to letters of credit to provide security on construction projects. In addition, it is not unusual for contractors to procure letters of credit in favor of sureties to secure performance of contracts. For these reasons, it may be valuable for contractors, subcontractors, owners and sureties to recognize the benefits, risks and peculiar aspects of the letter of credit device.

[12]For example, as we have seen, the customer may seek to enjoin the issuer's payment under the letter of credit. In addition, the issuer, for whatever reason, may decline to pay the beneficiary and potentially be liable for wrongful dishonor. The issuer, on the other hand, may decide to pay the beneficiary on nonconforming documents and thereby jeopardize its reimbursement rights or risk liability to its customer for wrongful honor. Even assuming payment by the issuer is proper, recovery options may be foreclosed because the customer is insolvent or bankrupt. Finally, the beneficiary is not immune from potential liability in a breach of warranty action.