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Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions

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I. AN INTRODUCTION TO LETTERS OF CREDIT

In both international and domestic sales transactions, the contract of sale determines the obligations of the buyer and the seller. In international sales transactions, a contract for the sale of goods is usually executed in conjunction with a banker's documentary credit to secure the prompt payment of the contract price.[1] Documentary credits are not typically used in domestic

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1. *See* C. SCHMITTHOFF, SCHMITTHOFF'S EXPORT TRADE 244-69 (7th ed. 1980);

sales transactions because the contractual risks are significantly reduced where both the parties to the contract and the performance of the contractual obligations will take place in one country. In addition, domestic trade in the United States involves fewer commercial uncertainties than does international trade due to such factors as nationwide postal and telecommunication services, the Uniform Commercial Code,[2] and a uniform judicial system. International sales transactions, on the other hand, often involve the cost and inconvenience of currency exchange restrictions and the risk of multiple lawsuits in disparate legal systems. For example, in a routine domestic sales transaction the seller simply tenders goods and the buyer pays for them. In a typical international sales transaction, a United States seller would probably balk at shipping goods to a foreign buyer before receiving payment for the goods, and the foreign buyer would likewise be reluctant to tender payment before inspecting the goods[3] to ensure that they conform to the contract.

Letters of credit[4] are used to reduce these problems and risks by introducing predictability and security into international sales transactions.[5] For centuries merchants have utilized letters of credit to facilitate trade among nations.[6] In a typical international documentary credit arrangement, a buyer instructs a domestic bank, the issuing bank,[7] to open a documentary credit for a for-

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see also H. FINKELSTEIN, LEGAL ASPECTS OF COMMERCIAL LETTERS OF CREDIT ch. 1 (1930); B. KOZOLCHYK, LETTERS OF CREDIT, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 5 (1980) [hereinafter cited as B. KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA]; B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS § 1.01[3] at 9 (1966) [hereinafter cited as B. KOZOLCHYK].

2. All cites to the UCC are to the 1978 version.

3. *See* UCC § 2-513(1) (1978); *see also* C. SCHMITTHOFF, *supra* note 1, at 92-95; A. SCHWARTZ & R. SCOTT, COMMERCIAL TRANSACTIONS 214-23 (1982).

4. A letter of credit is a written instrument addressed by one person to another that requests the latter to give credit to the person in whose favor it is drawn. A letter of credit is a negotiable instrument whereby a person requests another to advance money or give credit to a third person with a promise to repay the person making the advancement. An export letter of credit is issued by a foreign bank to a local seller that enables the seller to draw a draft on the foreign bank against shipment of the merchandise. BLACK'S LAW DICTIONARY 813, 814 (5th ed. 1979). *See* B. KOZOLCHYK, *supra* note 1, § 23.04[2] at 599.

5. *See generally* Davis, *Commercial Letters of Credit*, 5 SYDNEY L. REV. 14 (1965) ("commercial letters of credit . . . [are] the crankshaft of modern commerce") (citing CHORLEY, LAW OF BANKING 179 (4th ed. 1960)).

6. *See* B. KOZOLCHYK, *supra* note 1, § 1.01.

7. This Article uses the terms "issuing bank" and "confirming bank" inter-

eign seller. The issuing bank then instructs a bank designated by the foreign seller, the correspondent bank, to accept, negotiate, or pay the amount specified on the buyer's draft to the seller upon presentation of certain shipping and sales documents by the seller. The correspondent bank advises the seller of the specific documents that the seller must deliver before the correspondent bank will accept and pay the amount of buyer's draft. Finally, arrangements are made through customary banking channels for the transfer of payment between the issuing bank and the correspondent bank.[8]

The documents tendered by the seller to the correspondent bank typically must conform to the requirements contained in the letter of credit. When the seller tenders conforming documents, the correspondent bank is obligated to pay the seller the purchase price specified in the letter of credit. The correspondent bank's obligation to pay the seller upon presentation of the specified documents is not, however, conditioned on the buyer's prior receipt of the goods. The quintessence of all letter of credit arrangements is the fact that they are documentary sales.[9] The sole concern of the correspondent bank is that the documents tendered by the seller conform to the letter of credit specifications. Using letters of credit in international sales transactions serves the primary interests of both buyers and sellers. The seller's delivery of conforming documents to the correspondent bank simultaneously provides the foreign seller with prompt payment for the shipment of goods and the domestic buyer with symbolic delivery of conforming goods.[10]

Four basic contractual relationships exist in an international letter of credit transaction.[11] First, the underlying sales contract

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changeably when referring to the substantive rights of the seller under a letter of credit.

8. *See* B. KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 1, at 7-8; C. SCHMITTHOFF, *supra* note 1, at 247.

9. *See* UCC § 5-103(1)(b); *see also* INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, art. 8(a) (1974) [hereinafter referred to as UCP].

10. *See* B. KOZOLCHYK, *supra* note 1, § 5.02[1] at 147; C. SCHMITTHOFF, *supra* note 1, at 364.

11. United City Merchants Ltd. v. Royal Bank of Canada [1982] 2 W.L.R. 1039, 1044-45 (H.L.). Lord Diplock stated that "[i]t is trite law that there are four autonomous though interconnected contractual relationships involved." *Id.* at 1044.

creates rights and duties between the buyer and seller.[12] The addition of a letter of credit contract to the transaction does not alter these contractual rights and duties.[13]

Second, the letter of credit creates contractual duties and obligations for the buyer to deposit in the issuing bank the money necessary to finance the underlying sales contract.[14] If the buyer maintains an account with the issuing bank and the funds on deposit in the buyer's account equal or exceed the purchase price of the goods, the issuing bank may extend a letter of credit to the seller for the amount agreed upon in the letter of credit.[15] The deposit of money into an existing account for the exclusive purpose of purchasing a letter of credit contractually prohibits the issuing bank from using that money for any purpose other than the letter of credit. This contractual prohibition prevents the issuing bank from using money deposited for letter of credit purposes to satisfy any indebtedness the buyer might incur during the period of time that the letter of credit is in effect.[16] The bank's use of letter of credit funds to satisfy debts of the buyer would make the bank liable to both the seller for whom the credit was extended and to the buyer for breach of the contract of deposit.[17] A buyer may also, however, purchase letters of credit from the issuing bank for cash. In transactions where letters of credit

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12. This contractual relationship is based on "the underlying contract for the sale of goods, to which the only parties are the buyer and the seller." *Id.*

13. *See* 6 MICHIE ON BANKS AND BANKING ch. 12, § 30 (perm. ed. 1975).

14. This second contractual relationship is described as follows:

> [T]he contract between the buyer and the issuing bank under which the latter agrees to issue the credit and either itself or through a confirming bank to notify the credit to the seller and to make payments to or to the order of the seller (or to pay, accept or negotiate bills of exchange drawn by the seller) against presentation of stipulated documents; and the buyer agrees to reimburse the issuing bank for payments made under the credit. For such reimbursement the stipulated documents, if they include a document of title such as a bill of lading, constitute a security available to the issuing bank.

U.C.M., [1982] 2 W.L.R. at 1044. *See* Schmitthoff, *Confirmation in Export Transactions*, 1957 J. BUS. L. 17.

15. *See* H. FINKELSTEIN, *supra* note 1, at 168.

16. *Id.* at 168-69, n.61.

17. The bank's right to reimbursement may be established in terms of the letter of credit. While the right to reimbursement allows a bank to apply letter of credit funds to the debts of its customer, it does not relieve the bank from its obligations to pay the seller upon the presentation of conforming documents. *Id.* at 169, n.61.

are purchased for cash, money paid to the bank is not actually on deposit because, arguably, the purchaser has exchanged title to the money in return for the bank's obligations under the letter of credit. Another method of purchasing letters of credit, which avoids the requirement of depositing money with the bank, is to contract with the bank to issue the letter of credit either "against the promise of the buyer to indemnify the bank"[18] or as an extension of credit. This type of purchase arrangement often allows a buyer to defer repaying the bank until after the financed goods have been resold at the retail price.[19]

Third, a contractual relationship that may be revocable or irrevocable exists between the issuing bank and the seller. An irrevocable letter of credit contract gives the seller a cause of action against the issuing bank if the letter of credit is dishonored.[20] Correspondent banks that are merely advisory banks, however, are not liable to the seller for letters of credit that have been dishonored. A correspondent bank acting in an advisory capacity agrees only to serve as the fully-disclosed agent of the issuing bank and does not assume any personal liability. If the draft presented by the seller is dishonored by a correspondent bank acting in an advisory capacity, the seller should proceed directly against the issuing bank and against the buyer when appropriate.

At the time the seller presents the specified documents to the correspondent bank, the seller's goods usually are already in transit.[21] The seller, therefore, is placed in a somewhat precarious

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18. *Id.* at 170.

19. Annot., 35 A.L.R. 3d 1404, 1406 (1971).

20. *See* H. FINKELSTEIN, *supra* note 1, at 150.

21. In international sales transactions the parties generally will be operating under a C.I.F. contract. "The term C.I.F. means that the [contract] price includes in a lump sum the cost of the goods and the insurance and freight to the named destination." UCC § 2-320(1). *See also* UCC § 2-320(2)(a)-(e), which states in pertinent part:

> [A C.I.F. contract] requires the seller at his own expense and risk to
> (a) put the goods into the possession of a carrier . . . and obtain a negotiable bill or bills of lading . . . and
> (b) obtain a receipt . . . showing that the freight has been paid . . . and
> (c) obtain a policy . . . of insurance invoice . . . and
> (d) prepare an invoice of the goods . . . and
> (e) forward and tender all the documents[to the buyer].

Section 2-320 provides the standard requirements of C.I.F. contracts. The section is not always applicable in international trade; usually the International Chamber of Commerce (ICC) INCOTERMS (INCOTERMS 1980 replaced the

position because the goods have either already been delivered to the carrier or possession transferred to an agent, but the seller has not yet delivered the specified documents to nor received payment from the correspondent bank. If the correspondent bank is acting solely as the fully-disclosed agent of the issuing bank and refuses to pay on the draft upon presentation of conforming documents by the seller, the issuing bank has breached the terms of the letter of credit contract.[22]

Fourth, a contractual relationship often exists between the seller and the correspondent bank whereby the correspondent bank also becomes the confirming bank.[23] This Article has assumed that the correspondent bank acts solely in an advisory capacity as a fully-disclosed agent of the issuing bank with no personal liability of its own. In fact, the sole advisory role for the correspondent bank is seldom used. The seller is usually able to negotiate a term into the underlying sales contract whereby the letter of credit arrangement requires the correspondent bank also to be the confirming bank. A confirming bank undertakes the same obligations to the seller as does the issuing bank: to be primarily obligated to pay the seller in exchange for the documents specified under the letter of credit. The exporting seller benefits by having a local bank primarily obligated to pay on the delivery of the specified documents as confirmation by a local bank enhances the seller's likelihood of recovery should it become necessary for the seller to sue on the letter of credit.[24]

American Foreign Trade Definitions as revised in 1941) are incorporated into the international transaction by a specific contract term. The INCOTERMS are in accord with UCC provisions. *See* HARRIS BANK INTERNATIONAL TRADE GUIDE 118-20 (5th ed. 1981). Under a C.I.F. contract the buyer "must make payment against the tender of the required documents." UCC § 2-320(4).

22. The dishonor of a letter of credit by a correspondent bank also breaches the underlying C.I.F. contract. *See* UCC § 2-320(4).

23. The fourth contractual relationship is based on "the contract between the confirming bank and the seller under which the confirming bank undertakes to pay to the seller (or to accept or negotiate without recourse to drawer bills of exchange drawn by him) up to the amount of the credit against presentation of the stipulated documents." *U.C.M.*, [1982] 2 W.L.R. at 1045.

When payment is to be made through a confirming bank, the issuing bank authorizes the confirming bank to make such payments and to remit the stipulated documents to the issuing bank when they are received. The issuing bank in turn agrees to reimburse the confirming bank for payments made under the letter of credit. *Id.*

24. *See* C. SCHMITTHOFF, *supra* note 1, at 259-60.

II. THE JURIDICAL NATURE OF LETTERS OF CREDIT

Several different theories attempt to justify the legal rationale by which an irrevocable letter of credit imposes primary liability on the confirming bank. First, the binding nature of an irrevocable letter of credit is arguably derived *sui generis* from statute despite the apparent absence of consideration from the seller. The Uniform Commercial Practices (UCP) provides that a confirming bank undertakes "to pay . . . if the credit provides for payment."[25] It is the practice in international trade to adhere to this UCP provision and to consider the letter of credit to be binding on the issuing bank as soon as the credit is opened.[26] The courts of the United Kingdom have adopted the *sui generis* approach. In *United City Merchants Ltd. v. Royal Bank of Can-*

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25. UCP art. 3(b)(i). Article 3 provides in pertinent part:

a. An irrevocable credit constitutes a definite undertaking of the issuing bank, provided that the terms and conditions of the credit are complied with:

i. to pay . . . if the credit provides for payment . . . .

. . . .

b. [w]hen an issuing bank authorises or requests another bank to confirm its irrevocable credit and the latter does so, such confirmation constitutes a definite undertaking of the confirming bank in addition to the undertaking of the issuing bank, provided that the terms and conditions of the credit are complied with:

i. to pay . . . if the credit provides for payment . . . .

A 1983 revision by the ICC became effective as of October 1, 1984. *See* C. Schmitthoff, *The New Uniform Customs for Letters of Credit*, EXPORT 18,18-19 (May 1983).

26. A subsidiary question is whether the credit is opened when the issuing bank sends the notice advising the seller (beneficiary) of the letter of credit or when the seller actually receives the letter of credit. The author believes that the binding effect should occur *upon receipt* by the beneficiary of the issuing bank's letter. The issuing bank initiates the letter of credit, so until the beneficiary is aware that a credit has been opened, there can be no acts in reliance on that credit, and, therefore, no legal implications would attach. The legal rationale associated with the making of an offer in contract law, and its interpretation in the context of the "mailbox rule," is also compelling here. Applying this reasoning to an irrevocable letter of credit arrangement means that the credit would remain revocable from the time the letter of credit was dispatched by the issuing/confirming bank until it was received by the beneficiary. The arrangement would be irrevocable when the beneficiary received the letter or advice of the credit. *See* B. KOZOLCHYK, *supra* note 1, § 18.04; *see also* UCC § 5-106(1)(b) (discussing the timing and effect of the establishment of credit for the beneficiary).

ada,[27] Lord Diplock declared a confirmed letter of credit to be a "contract between the confirming bank and the seller under which the confirming bank undertakes to pay to the seller . . . up to the amount of the credit against presentation of the stipulated documents."[28] In a frequently quoted passage from the earlier case of *Malas v. British Imex Industries*,[29] Jenkins, L.J. declared:

> [T]he opening of a confirmed letter of credit constitutes a bargain between the banker and the vender of the goods, which imposes upon the banker an absolute obligation to pay . . . . *An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character*, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice.[30]

Neither court analyzed the contractual components in detail—they simply recognized the existence of a valid contract. In English common law, therefore, the confirmation contract is simply a legal phenomenon derived *sui generis* from the UCP and recognized by the courts.[31]

Second, the rights and obligations of the seller (beneficiary) and confirming bank may be analyzed in the context of the third-party beneficiary theory.[32] The rights and obligations of the seller under the third-party beneficiary theory depend totally upon the rights and obligations set forth in the contract between the confirming bank and the issuing bank—rights and obligations which undoubtedly parallel those contained in the contract between the issuing bank and its customer, the buyer. As the third-party beneficiary to the contract between the confirming bank and the issuing bank, the seller must comply with the terms contained in the issuing bank's instructions to the confirming bank in order to receive payment.[33] If the terms embodied in the confirming bank's instructions to the seller are more onerous than the terms of the underlying contract between the buyer and seller, the seller is required to conform to the more burdensome terms in the confirm-

27. [1982] 2 W.L.R. 1039.
28. *Id.* at 1045.
29. [1958] 2 Q.B. 127 (C.A.).
30. *Id.* at 129 (emphasis added).
31. *See id.*
32. *See* E. FARNSWORTH, CONTRACTS 709-44 (1982).
33. *See* UCP art. 7; *see also* B. KOZOLCHYK, *supra* note 1, § 19.01.

ing bank's instructions in order to receive payment.[34] A seller cannot force payment from the confirming bank simply on the basis of its underlying contract with the buyer.[35]

The converse is also true. A seller need comply only with the instructions it receives from the confirming bank, even if the confirming bank's instructions to the seller dilutes the stringency of any terms contained in the underlying contract between the buyer and seller. A buyer, likewise, will not be able to prevent the confirming bank from paying the seller by proving that its underlying contract with the buyer included provisions that were more onerous than those contained in the confirming bank's instructions to the seller.[36] The third-party beneficiary theory as a rationale for imposing primary liability on the confirming bank, therefore, is not at all convincing.

A third theory considers the confirming bank's letter to the seller that sets forth the conditions prerequisite to payment to be an offer.[37] In order for the confirming bank's advisory letter to the seller to be an offer, however, bargained-for consideration must be identified. The law of contracts generally provides that an offer may be withdrawn at any time prior to acceptance or upon receipt of consideration by the offeror. Under this "offer" theory, a confirming bank that has yet to receive any consideration in return for its advisory letter should be able to revoke the offer. In letter of credit transactions, however, the confirming bank is irrevocably bound as soon as the seller receives the advisory letter that sets forth the offer.[38] This theory, therefore, also fails to convincingly explain the binding nature of the confirmation arrangement.

A fourth and much more persuasive theory also considers the advisory letter sent by the confirming bank to be an offer, but suggests in addition that the confirming bank is in effect bargaining for *performance* in the form of the seller's presentation of the documents specified in the confirming bank's letter.[39] When the

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34. *See* UCP art. 8.
35. *See id.*
36. *See id.*
37. *See* B. KOZOLCHYK, *supra* note 1, at 135-43.
38. *See* B. KOZOLCHYK, *supra* note 1, § 18.04.
39. This approach answers the drawbacks and criticisms presented in the analysis of the offer theory as set out in B. KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 1, at 135-43. Furthermore, the author believes that modern interpretations of the contract law theory of reliance have displaced the tradi-

seller, as offeree, begins the performance invited by the confirming bank's advisory letter, a secondary option contract is arguably created.[40] Support for this option contract theory is found in the Restatement (Second) of Contracts: "An offer which the offeror [confirming bank] should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree [seller] before acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice."[41]

A confirming bank should expect its advisory letter to "induce action . . . of a substantial character on the part of the [seller]."[42] The seller is not considered to have accepted the letter of credit contract until the documents specified in the advisory letter are presented to the confirming bank. An essential element of option contracts is that time be of the essence. This requirement is met because the seller only has the limited period of time specified in the confirming bank's letter[43] in which to accept the offer.[44] The typical international sales transaction,[45] however, requires the

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tional offer theory as set forth in McCurdy, *Commercial Letters of Credit*, 35 HARV. L. REV. 539, 569 (1922); *see also* Harfield, *Identity Crises in Letter of Credit Law*, 24 ARIZ. L. REV. 239, 251 (1982).

The preexisting duty rule, *see* McCurdy, *supra*, is an appropriate defense to a claim of lack of consideration when raised *by the buyer in his own behalf* because the seller owes a legal duty to the buyer, *not* to the confirming bank (the actual promisor on the confirmation obligation). *See* RESTATEMENT (SECOND) OF CONTRACTS § 73 and illustration 12 (1979) (repudiates the reasoning adopted in McDevitt v. Stokes, 174 Ky. 515, 192 S.W. 681 (1917) where a duty owed a third party effectively deprived a performance of the status of consideration when the performance was rendered in return for the promise of a separate sum); *see also* E. FARNSWORTH, CONTRACTS 271-77 (1982).

40. "Where an offer invites an offeree to accept *by rendering a performance and does not invite a promissory acceptance*, an option contract is created when the offeree tenders *or begins the invited performance* or tenders a beginning of it." RESTATEMENT (SECOND) OF CONTRACTS § 45(1) (emphasis added).

41. *Id.* § 87(2).

42. *Id.*

43. UCP art. 37 provides: "All credits, whether revocable or irrevocable, must stipulate an expiry date for presentation of documents for payment, acceptance or negotiation."

44. If no exact time is specified in the letter the confirming bank is obligated to keep the credit open for a reasonable period of time—the reasonableness being measured by the particular circumstances of each case. *See* C. SCHMITTHOFF, *supra* note 1, at 254-55.

45. These contracts are commonly referred to as C.I.F. or F.O.B. contracts.

seller to contract with a carrier for the transportation of the goods as well as the placement of those goods in the possession of the carrier. Some international sales contracts[46] also require the seller to insure the contract goods against any damage or loss incurred during transport. The contracts for carriage and insurance create significant contractual obligations for the seller and, thus, are clearly acts of a substantial character that have been induced by the confirming bank's offer.[47] The parties must enter into carriage and insurance contracts before the seller can formally accept the letter of credit contract, which permits the seller to obtain the bill of lading and appropriate insurance policies. The bill of lading, insurance policies, and the invoice all must be presented to the confirming bank within the period of time specified in the advisory letter.

The seller's change of position in reliance on the advisory letter offer makes the offer binding on the confirming bank as offeror, so it is both critical and equitable for the offer to remain open for its stated duration.[48] The seller must have the full time allotment in which to perform the acts specified by the advisory letter and present the required documents to the confirming bank.[49] It would be a grave injustice to deny a seller payment after the seller has arranged for the shipment of the contract goods and insured those goods for transport. In effect, the carriage and insurance obligations incurred by the seller is consideration for the confirming bank's contractual duty to keep the offer open.[50] Thus, under this theory, the presentation of conforming documents in accordance with the confirming bank's instructions represents acceptance of the primary letter of credit contract, which then dis-

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For an explanation of C.I.F. contracts, see *supra* note 21. For an explanation of both see ICC INCOTERMS 1980.

46. C.I.F. contracts.

47. *See* RESTATEMENT (SECOND) OF CONTRACTS § 87(2).

48. An offer must remain open for the period of time specified in the advisory letter or for a reasonable time. *See supra* note 44.

49. RESTATEMENT (SECOND) OF CONTRACTS § 45(2) provides: "The offeror's duty of performance under any option contract so created is conditional on completion or tender of the invited performance in accordance with the terms of the offer."

50. It is important to remember that the seller's legal duty is owed to the buyer and not to the confirming bank—the actual promisor on the confirmation obligation. *See* RESTATEMENT (SECOND) OF CONTRACTS § 73 and illustration 12; *see also* E. FARNSWORTH, CONTRACTS 271-77 (1982).

charges or supersedes the secondary option contract.[51] The confirming bank's acceptance of the shipping documents crystallizes its obligation to pay in accordance with the terms of its advisory letter to the seller.[52]

The presentation of noncomplying documents constitutes a counteroffer by the seller,[53] which may be rejected by the issuing bank. At common law the counteroffer would repeal the bank's original offer,[54] but the option contract created by the seller's commencement of performance preserves the issuing bank's original offer unless the requirements for discharge of the contractual duty have been met.[55]

III. THE MECHANICS OF ISSUING LETTERS OF CREDIT

Commercial letter of credit transactions ordinarily consist of four successive stages: (1) the buyer opens the credit at the issuing bank; (2) the issuing bank communicates the credit to the seller; (3) the seller or his agent presents the draft, demand, or receipt of payment, accompanied by specified documents to the correspondent bank; and (4) the confirming bank makes its acceptance and payment to the seller.[56] A buyer applies for a letter of credit with an issuing bank by means of a standard form in which the buyer enumerates the terms to be included in the letter of credit, states whether the credit will be revocable or irrevoca-

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51. *See supra* note 49. *See also* NYUCC § 5-101 practice commentary (McKinney 1964); Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 599 (1978); Harfield, *Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92, 105 (1962).

52. *See supra* note 49.

53. "Presentation of documents that are almost the same or which will do just as well *is a counter-offer* that the issuer is entitled to reject. Were it otherwise, the issuer would sustain liability on account of an obligation he never undertook." Harfield, *Identity Crises in Letter of Credit Law*, 24 ARIZ. L. REV. 239, 251 (1982) (emphasis added).

54. RESTATEMENT (SECOND) OF CONTRACTS § 36 provides: "(1) An offeree's power of acceptance *may* be terminated by (a) rejection *or counter-offer* by the offeree. . . ." (emphasis added); *see also id.* § 39(2), which provides: "An offeree's power of acceptance *is terminated by his making of a counter-offer*, unless the offeror has manifested a contrary intention or unless the counter-offer manifests a contrary intention of the offeree." (emphasis added).

55. *See id.* § 37. The right to accept, however, is still limited by the express expiry date. *See supra* notes 43 and 44.

56. B. KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 1, at 7.

ble,[57] and specifies whether the seller's drafts are to be sight drafts or time drafts.[58]

The buyer also will specify the documents that the seller must present to the correspondent bank in order to receive payment. It is essential that the seller present conforming documents. The specific requirements of this clause, therefore, are of great concern to both the seller and the issuing bank. Because most international trade involves ocean shipping, a marine insurance policy is ordinarily one of the conforming documents that is required to be presented.[59] The seller must also tender a commercial invoice that specifically describes the goods to be shipped under the contract in order to receive payment.[60] The correspondent bank then compares the invoice description of the goods with the description contained in the letter of credit contract, and can reject the invoice as nonconforming if there are any discrepancies.[61] A correspondent bank's rejection of goods as nonconforming based upon discrepancies between the invoice and letter of credit contract does not constitute a breach of contract by the rejecting bank. Therefore, a rejection relieves the correspondent bank and the issuing bank from liability for refusing to honor the seller's drafts.

In practice, however, the buyer does not usually require the goods to be described with specificity in the letter of credit contract. The complex nature of many international sales transactions precludes a complete and accurate comparison of the in-

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57. Irrevocable credits are normally used. *See* A. LOWENFELD, INTERNATIONAL PRIVATE TRADE 91, n.i (1975) ("Revocable letters of credit exist, but . . . their purpose is simply to facilitate payment, without having the risk allocation function that the irrevocable letter has.")

58. *See* 2A J. RABKIN & M. JOHNSON, LEGAL FORMS WITH TAX ANALYSIS 5C-1020 (1984). A sight draft is payable upon presentment to the issuing bank. UCC § 3-108. A time draft allows for a delay between the time the seller ships the goods and the time the issuing bank honors the draft. The delay gives the buyer the advantage of receiving delivery of the goods before the issuing bank is obligated to pay the seller on his matured drafts. The use of time drafts obviates the need for the buyer to obtain an injunction to stop payment when problems arise. As compensation for this trading advantage, and for use of the money during the interim period, the seller will usually demand a premium in addition to the customary contract price.

59. *Id.* at 5C-1006. A C.I.F. contract ordinarily requires the seller to insure the goods under a policy of marine insurance.

60. *See* H. HARFIELD, BANK CREDITS AND ACCEPTANCES 57 (1974).

61. *See id.* at 57-58.

voice and letter of credit descriptions by the correspondent bank.[62] Furthermore, the commercial invoice description of the goods need not be exact in order to preserve the buyer's right to reject the goods since the buyer can always sue the seller on the underlying sales contract for goods that do not conform to the description set forth in the sales contract.[63] Finally, most international sales contracts require a bill of lading.[64] The bill of lading is evidence to the buyer that the goods have been put "on board" a ship that is destined for the buyer's specified point of delivery. A bill of lading is made to the order of the issuing bank and shows the date on which goods are shipped.[65] A buyer ordinarily contracts for a "clean" bill of lading.[66]

After the issuing bank accepts a letter of credit application, it issues a letter of credit consistent with the terms contained in the buyer's application. The issuing bank instructs a correspondent bank of the letter of credit and its terms, and the correspondent bank then issues an "Advice of Irrevocable Credit" that sets forth the terms of the letter of credit to the seller. If the correspondent bank is also the confirming bank, it also issues a confirmed letter of credit to the seller which specifies its own obligations as the confirming bank.[67]

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62. *Id.* at 58-59.

63. *Id.*

64. C.I.F. contracts usually require a bill of lading. *See* J. RABKIN & M. JOHNSON, *supra* note 58, at 5C-1011. The buyer ordinarily requires the seller to produce a "full set of on board bills of lading to the order of [the issuing bank]. . . and dated on or before [shipping date] evidencing shipment . . . ." *Id.; see also* UCC § 1-201(6) which defines a bill of lading as "a document evidencing the receipt of goods for shipment issued by a person engaged in the business of transporting or forwarding goods . . . ."

65. *See* J. RABKIN & M. JOHNSON, *supra* note 58, at 5C-1011.

66. A "clean" bill of lading contains no additions or deletions from that required by the underlying contract that would indicate that the goods shipped are nonconforming. *See* Liberty Nat'l Bank and Trust Co. v. Bank of Am. Nat'l Trust and Sav. Ass'n, 218 F.2d 831, 838 (10th Cir. 1955).

67. *See* Schmitthoff, *Confirmation in Export Transactions*, 1957 J. BUS. L. 17; *see also* H. GUTTERIDGE & M. MEGRAH, THE LAW OF BANKERS' COMMERCIAL CREDITS 69 (6th ed. 1979).

IV. IRREVOCABILITY, FRAUD, AND INJUNCTION

A. Introduction

Letters of credit are made irrevocable in order to bind the issuing and confirming banks to their promise to pay the seller upon the presentation of conforming documents. In a typical letter of credit transaction, the issuing or confirming bank can only examine the tendered documents themselves to determine whether or not the letter of credit requirements have been met. The underlying contract between the seller and the buyer is not considered to be the bank's concern.[68]

The duty of the confirming or issuing bank to be bound by the terms of an irrevocable letter of credit stabilizes international sales transactions because both buyers and sellers can rely on the bank as a conduit of funds and not as a third party to their underlying sales contract. Recently, however, the increasing use of injunctions by the courts in response to allegations of fraud in the underlying sales contract have subjected this stable relationship to the threat of collapse.[69]

An action for fraud that seeks the equitable remedy of an injunction is the buyer's most common method of blocking payment in a letter of credit transaction. In practice, the buyer usually attempts to enjoin the issuing bank from paying on the seller's

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68. *See* UCP art. 8(a), which states: "In documentary credit operations all parties concerned deal in documents and not in goods." *See also* UCC § 5-114(1). UCC § 5-114, comment 1 states that any attempt by a bank to reserve the right to dishonor if the documents do not conform to the underlying contract would be "declared invalid as essentially repugnant to an irrevocable letter of credit."

69. *See* Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596 (1978); Justice, *Letters of Credit: Expectations and Frustrations*, (pts. 1-2) 94 BANKING L.J. 424, 430, 493 (1977); *see also* Geva, *Contractual Defenses as Claims to the Instrument: The Right to Block Payment on a Banker's Instrument*, 58 OR. L. REV. 283 (1979); Harfield, *Identity Crises in Letter of Credit Law*, 24 ARIZ. L. REV. 239, 242 (1982); Symons, *Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338 (1980); Note, *A Reconsideration of American Bell International, Inc. v. Islamic Republic of Iran*, 19 COLUM. J. OF TRANSNAT'L L. 301 (1981); Note, *Judicial Development of Letters of Credit Law: A Reappraisal*, 66 CORNELL L. REV. 144 (1980); Note, *"Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution*, 93 HARV. L. REV. 992 (1980); Note, *Letters of Credit: Injunction as a Remedy for Fraud in UCC Section 5-114*, 63 MINN. L. REV. 487 (1979).

drafts,[70] which puts the issuing bank "on the horns of a dilemma." On one hand, the issuing bank is the agent of its customer, the buyer, and subject to the buyer's control. On the other hand, the issuing bank is bound by its irrevocable promise in the letter of credit to pay the seller upon the presentation of conforming documents.[71]

B. United States Decisions

The general rule of law in letter of credit transactions is that it is inappropriate for a court to enjoin the issuing bank from paying a seller on the basis of a dispute between the buyer and seller that arises out of the underlying sales contract, absent some compelling equities.[72] For example, in *Maurice O'Meara Co. v. National Park Bank*,[73] a correspondent bank justified its refusal to honor a seller's drafts by claiming that the tensile strength of the newsprint sent per the specifications of the underlying sales contract did not conform to the specifications set forth in the letter of credit contract.[74] The seller filed suit asserting that the letter of credit did not require the bank to examine the quality of the goods purchased under the letter of credit contract.[75] Ruling in favor of the seller, the New York Court of Appeals held that the bank had neither the right to demand that the paper be tested for tensile strength nor the right to inspect the paper itself unless the letter of credit specifically included such provisions.[76] The presentation of documents, which on their face conformed to the terms

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70. *See Letters of Credit*, *supra* note 69; *see also* H. FINKELSTEIN, *supra* note 1 at 171.

71. *See* H. GUTTERIDGE & M. MEGRAH, THE LAW OF BANKERS' COMMERCIAL CREDITS 60-61 (6th ed. 1979); C. SCHMITTHOFF, *supra* note 1 at 259; *see also* 6 MICHIE ON BANKS AND BANKING ch. 12, § 32, at 423-24 (perm. ed. 1975).

72. *See* A. LOWENFELD, INTERNATIONAL PRIVATE TRADE 109-11 (1975); *see also* Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 606-11 (1978).

73. 239 N.Y. 386, 146 N.E. 636 (1925).

74. *Id.* at 394, 146 N.E. at 638. Rather than limiting its scrutiny to the *documents* as required by letter of credit obligations, the bank had examined the *goods* to determine whether they were in conformity with the underlying sales contract. *See* UCP art. 8(a); *see also* UCC § 5-114(1), comment 1, *supra* note 68.

75. *See* 239 N.Y. at 392-93, 146 N.E. at 638. The seller alleged that the correspondent bank's only duty was to ensure that the specified documents conformed to the letters of credit requirements.

76. *Id.* at 396-97, 146 N.E. at 639.

of the letter of credit, required the bank to pay the seller.[77] Justice Cardozo, in his dissenting opinion, however, declared:

> We are to bear in mind that this controversy is not one between the bank . . . and . . . a holder of the drafts who has taken them without notice and for value. The controversy arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated, payment *may be resisted* if the documents are false.[78]

While recognizing that the fraud defense would be ineffective against a holder in due course,[79] Justice Cardozo implied that if the seller presenting the drafts for payments had perpetrated the fraud, the issuing bank may then be entitled to refuse payment if the documentary fraud was discovered before payment was due.[80] Justice Cardozo's dissent suggests that any discrepancies between the goods actually shipped and the goods described in the letter of credit documents could be treated as proof that the documents did not conform to the letter of credit. Such a conclusion would properly support a refusal by the issuing bank to honor the seller's draft on grounds of nonconformity of the tendered documents.

The landmark "fraud in the letter of credit" case in the United States is considered to be *Sztejn v. J. Henry Schroder Banking Corp.*[81] In *Sztejn*, the Supreme Court of New York County ruled that an injunction which prohibited the issuing bank from paying on the seller's drafts was proper where the seller was contractually obligated to deliver bristles, but instead shipped worthless boxes of cowhair, garbage, and rubbish.[82] The court held:

> No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish . . . [and] where the bank has been given notice of the fraud before being

77. *Id.*
78. *Id.* at 401-02, 146 N.E. at 641 (emphasis added).
79. *See* UCC § 3-305.
80. 239 N.Y. at 402, 146 N.E. at 641.
81. 177 Misc. 719, 31 N.Y.S.2d 631 (1941).
82. *Id.* at 723, 31 N.Y.S.2d at 635. The central issue in *Sztejn* was a determination of the duties and liabilities of the issuing bank. The court noted that the terms of the letter of credit are controlling. It is the presentation of the appropriate shipping documents, not delivery of the goods, which obligates the issuing bank to pay. *Id.* at 721, 31 N.Y.S.2d at 633.

presented with the drafts and documents for payment. . . .[83]

The court distinguished *Maurice O'Meara* by emphasizing that the issue in this case was not a question as to the quality of the goods, but the fact that no goods (other than worthless rubbish) had been shipped.[84] The *Szetjn* court cited with approval the portion of Cardozo's dissent in *Maurice O'Meara*[85] which declared that a shipment of goods that was different from those described in the letter of credit documents would cause documents to lack the requisite conformity because they failed to state truthfully what had actually been shipped.[86]

The court's reasoning in *Sztejn* was followed in two later cases: *Merchants Corp. of America v. Chase Manhattan Bank, N.A.*[87] and *Dynamics Corp. of America v. Citizens and Southern National Bank*.[88] In *Merchants*, the buyer notified the issuing bank that the documents accompanying the seller's drafts were forgeries and sought to enjoin payment on the presentment of the allegedly fraudulent documents.[89] The buyer alleged that the documents were fraudulent because they stated that the goods had been shipped by the date specified in the contract when, in fact, they had not.[90] The New York Supreme Court treated the case as

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83. *Id.* at 723, 31 N.Y.S.2d at 635. Although performance of the underlying contract between the buyer and seller is generally immaterial and inadmissible when determining the propriety of the issuing bank's actions, the court ruled that when the bank was aware of fraud in the underlying transaction, the fundamental principle of separation which defined the bank's obligation to the seller in letter of credit transactions should not protect the defrauding seller. The court went on to distinguish a breach of warranty from active fraud in the context of commercial transactions. *Id.* at 722, 31 N.Y.S.2d at 634-35.

84. *Id.* at 721, 31 N.Y.S.2d at 633-34.

85. *Id.* at 723, 31 N.Y.S.2d at 635.

86. *See supra* text accompanying note 80.

87. 5 UCC REP. SERV. 196 (N.Y. Sup. Ct. Mar. 5, 1968).

88. 356 F. Supp. 991 (N.D. Ga. 1973). *Dynamics* is a diversity case involving Georgia's version of UCC § 5-114. *See* GA. CODE ANN. § 109 A-5-114(2)(b) (1979 & Supp. 1984).

89. *See* 5 UCC REP. SERV. at 197.

90. *Id.* at 196. Plaintiffs became suspicious when three weeks elapsed between the agreed date for loading the goods in Korea and the date the documents were presented to the issuing bank for payment. After obtaining an order to show cause, the buyer conducted an investigation that disclosed that the goods had in fact been loaded after the agreed date of January 31, 1968, although the letter of credit documents stated that the deadline, which was a condition for honoring the seller's drafts, had been met. Defendant asserted that the *documents* complied with the requirements of the letter of credit in all re-

a single dispute involving the terms of the letter of credit and, following *Sztejn*, reasoned that because the issuing bank had knowledge of the forgery before the presentment of the seller's draft and the bank's reliance upon this knowledge was based "upon reasonable inquiry in the exercise of due care,"[91] the bank was not required to honor the seller's drafts and issued an injunction against payment.[92]

In *Dynamics*, Dynamics Corporation of America (DCA) contracted to sell defense-related communications equipment to the Government of India.[93] In order to pay for this equipment, India established a credit arrangement with the United States Government whereby the United States Government would pay DCA the purchase price of the equipment when DCA's invoices were presented by the Indian Government and accompanied India's certification of specified facts.[94] Under the contract DCA also agreed to purchase irrevocable letters of credit from the issuing bank, Citizens and Southern National Bank, in favor of the Indian Government at intervals that corresponded to the presentation of invoices to India by DCA. A letter of credit would be payable to India upon India's submission of certification to the issuing bank that DCA had failed to perform its contractual obligations.[95] Subsequent to the time that performance began under the contract, India went to war with Bangladesh.[96] In response to India's role in the war, the United States placed a partial embargo on military supplies going to India. The embargo included the communications equipment sold by DCA. India, in turn, refused to certify any of DCA's invoices for payment and attempted to draw upon the standby irrevocable letters of credit by submitting certification to the issuing bank that DCA had failed to perform its contractual obligations.[97] DCA sought to enjoin the issuing bank from honoring any of India's drafts drawn under the letter of credit agreement by claiming that it was the embargo of the United States Government, not any failure by DCA, that had caused the equipment not to be delivered and, thus, the certifi-

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spects. *Id.*

91. *Id.* at 197.
92. *Id.* at 198.
93. 356 F. Supp. at 993.
94. *Id.*
95. *Id.* at 993-94.
96. *Id.* at 994.
97. *Id.* at 994-95.

cate submitted by India was fraudulent.[98] DCA based its allegation on a provision in the underlying sales contract that detailed the proper means by which DCA was to deliver the equipment. The Government of India, however, contended that the letter of credit transactions were documentary sales and, therefore, were independent of the underlying sales contract.

Although the District Court for the Northern District of Georgia reiterated the general rule that letters of credit are independent of the primary sales contract, it recognized that the facts of *Dynamic* presented a unique situation. The letters of credit were purchased to give India added security for DCA's performance not to obtain prompt payment.[99] The court found it conceptually difficult to apply the *Sztejn* concept of fraud to the complicated intergovernmental situation in *Dynamic*, but granted DCA's request for a preliminary injunction against payment on other grounds[100] and ruled that the question of fraud was an issue of

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98. *Id.* at 996. DCA's claim for injunctive relief was two-pronged. First, DCA alleged that the certificate submitted by India which claimed DCA had breached its contractual obligations was erroneous and fraudulent since DCA, by reason of the F.O.B. shipping term in the contract, had affected proper delivery of the equipment when it was prevented from shipping solely because of the United States embargo. Second, DCA alleged that the certificate required to accompany the sight draft was not in strict compliance with the letter of credit specifications because it was not signed by the President of India. *Id.*

India argued first that the court could not even consider the underlying sales contract because letter of credit transactions deal only with documents, and second that it was a ridiculous and erroneous interpretation of the letter of credit to contend that the President of India was actually required to sign the certificate. *See id.* at 996-97. "India notes that the Constitution of the Union of India empowers the Joint Secretary to the Government to sign documents on his President's behalf and that the Joint Secretary signed other agreements on his President's behalf in dealings with DCA without objection from DCA." *Id.* at 997.

99. *Id.* at 996. DCA received prompt payment for deliveries to India under the contract from the United States Government. *See supra* text accompanying note 94.

100. The court stated that:

> A preliminary injunction is designed to preserve the status quo . . . . An injunction against the Bank would merely require it to continue holding on to the Deposit. If plaintiff's application were denied, the Deposit would be on its way to India, as would plaintiff's remedy, and plaintiff, which has already filed a petition in bankruptcy, would be severely disadvantaged . . . . It would not appear that India would be seriously disadvantaged by some further delay and the entry of a preliminary injunction . . . . Accordingly, the court concludes that a preliminary injunction is warranted.

Id. at 999-1000.

fact to be explored at trial.[101] The court asserted, however, that a permanent injunction against payment would be proper if the trial court determined that India's certificate was fraudulent.[102]

C. The Uniform Commercial Code

The comprehensive regulation of letters of credit is codified in Article 5 of the Uniform Commercial Code (UCC).[103] Prior to the passage of Article 5, the principles applied in regulating letters of credit in the United States were drawn from either the UCP or New York case law.[104] Section 5-114(1) mandates the doctrine of separation[105] by providing:

> An issuer *must* honor a draft or demand for payment which complies with the terms of the relevant credit *regardless of whether*

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101. *Id.* at 998.

102. *Id.*

103. *See* B. KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 1, at 11.

104. New York case law was applied in the regulation of letters of credit because of the dominance of the port of New York in international trade. *See* NYUCC § 5-101 official comment and New York annotations (McKinney 1964). After article 5 was enacted the New York Legislature chose to retain the UCP through section 5-102(4) of its UCC, subject to the intention of the parties who created the letter of credit and subjected themselves to New York law.

Some commentators have suggested that this legislative choice "amounts to an abdication by the New York Legislature and in practice will probably be an incorporation by reference of the UCP." NYUCC § 5-102 practice commentary (McKinney 1964). The New York Legislature's decision undoubtedly stemmed from the potential multi-billion dollar loss of international trade that might have resulted from forcing importers and exporters to abandon centuries of empirically developed common law for new and untried statutory regulations.

Section 5-102(4) provides:

> Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the thirteenth or any subsequent Congress of the International Chamber of Commerce.

NYUCC § 5-102(4).

Alabama and Missouri have also adopted the "New York Amendment." UCC § 5-102, 2A U.L.A. 226 (1985). For a discussion on how portions of Article 5 might seep into commercial credit transactions governed by the UCP, see Eberth & Ellinger, *Assignment and Presentation of Documents in Commercial Credit Transactions*, 24 ARIZ. L. REV. 277, 296-97 (1982).

105. *See* H. GUTTERIDGE & M. MEGRAH, THE LAW OF BANKERS' COMMERCIAL CREDITS 62-65, 88-94 (6th ed. 1979).

> *the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.* The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.[106]

Section 5-114(1), however, does not mention the companion doctrine of strict compliance.[107] Pre-Code case law, therefore, must be applied to determine whether documents are in compliance with the letter of credit terms.[108] Because pre-Code case law in New York adhered to the doctrine of strict compliance,[109] and that doctrine continues to be applied in New York courts,[110] adherence to the doctrine presumably continues elsewhere "via [UCC] section 1-103 on supplemental general principles."[111] The failure of UCC section 5-114(1) to mention the doctrine of strict compliance appears to be of little significance.

UCC section 5-114(2) codified the *Sztejn* holding by providing that:

> Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title . . . or of a certificated security . . . or is forged or fraudulent or there is fraud in the transaction: (a) the issuer must honor the draft or demand for payment if honor is demanded by a . . . holder in due course . . . and (b) in all other cases as against its customer, an issuer acting in good faith *may* honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents *but* a court of appropriate jurisdiction may enjoin such honor.[112]

Other courts have applied the *Sztejn* principles in similar fact

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106. UCC § 5-114(1) (emphasis added).

107. *See* B. KOZOLCHYK, *supra* note 1, at 259-62; *see also* C. SCHMITTHOFF, *supra* note 1, at 248-50; *see generally* R.B. Schlesinger Study, 3 N.Y. STATE REPORT OF THE LAW REVISION COMMISSION FOR 1955, at 1571-1719 (1955).

108. "[C]ourt decisions must serve as a source of gap-filler law under Article Five." J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 718 (2nd ed. 1980).

109. *See* B. KOZOLCHYK, *supra* note 1, at 258-59 and cases cited in n.5.

110. *See* J. WHITE & R. SUMMERS, *supra* note 108, at 729.

111. *Id.* (footnote omitted).

112. UCC § 5-114(2) (emphasis added).

situations. In *United Bank v. Cambridge Sporting Goods Corp.*,[113] the New York Court of Appeals relied on *Sztejn* and UCC section 5-114 in denying payment to a seller under a letter of credit transaction. In *United Bank*, the buyer, Cambridge Sporting Goods (Cambridge), contracted to purchase boxing gloves from the seller, Duke Sports (Duke), a Pakistani corporation. Cambridge opened an irrevocable letter of credit with United Bank (issuing bank) in favor of Duke. After denying Duke's request for an extension of time for performance on the underlying contract, Cambridge cancelled the entire arrangement with Duke and notified the issuing bank of the cancellation. In spite of the cancellation, Duke sought payment on the letter of credit by presenting conforming documents. An inspection of the goods upon their arrival revealed that Duke had shipped old, unpadded, ripped, and mildewed gloves, not the new gloves required by the underlying contract. Cambridge, therefore, sought to enjoin the issuing bank from paying Duke under the letter of credit. The court denied payment to Duke on the strength of the principles articulated in *Sztejn* and UCC section 5-114.[114]

Several other jurisdictions have recognized the *Sztejn* case as either a basis for UCC section 5-114 or as an exception to the general rule that a letter of credit is independent of an underlying sales contract.[115] Although courts vary in their willingness to grant injunctive relief, a *clear* showing of active fraud in the underlying transaction should enable a buyer to obtain injunctive relief.

D. United Kingdom Decisions

The doctrine set forth in *Sztejn* was first recognized by English courts in the 1975 case of *Discount Records v. Barclays Banks*.[116]

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113. 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976).

114. *Id.* at 259, 360 N.E.2d at 948, 392 N.Y.S.2d at 270. The court commented that § 5-114(2) "represents a codification of precode case law most eminently articulated in the landmark case of *Sztejn v. Schroeder Banking Corp.*" *Id.*

115. *See* Dynamics Corp. of Am. v. Citizens S. Nat'l Bank, 356 F. Supp. 991 (N.D. Ga. 1973); Edgewater Const. Co. v. Wilson Mfg. & Fin., 44 Ill. App. 3d 220, 357 N.E.2d 1307 (1976); Shaffer v. Brooklyn Park Garden Apts., 311 Minn. 452, 250 N.W.2d 172 (1977); O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 250 S.E.2d 587 (1978); Intraworld Indus. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316 (1975).

116. [1975] 1 W.L.R. 315 (Ch.).

While recognizing the persuasive authority of *Sztejn*, the *Discount* court refused to grant the buyer an interlocutory injunction to stop payment on a draft issued under a letter of credit agreement.[117] A buyer contracted to purchase certain records and cartridges from a French company and arranged for the purchase to be financed through a letter of credit. The buyer instructed the issuing bank to issue an irrevocable, confirmed letter of credit in favor of the French seller.[118] Upon receipt of the goods, the buyer discovered that only a fraction of the goods complied with the terms of the contract, the remainder being rubbish or goods that had not been ordered.[119] Relying on the reasoning of the Supreme Court of New York in *Sztejn*, the buyer attempted to enjoin the issuing bank from paying on the seller's draft.[120] The *Discount* court denied the buyer's request for temporary injunctive relief,[121] and distinguished *Sztejn* on two grounds. First, because the *Sztejn* court was ruling on a motion to dismiss a cause of action for failure to state a claim upon which relief could be granted, it was required to assume that the facts alleged were true.[122] Thus, the *Sztejn* court was dealing with a case of established fraud. In *Discount*, however, the buyer had made an allegation of fraud, but the fraud itself had not yet been established.[123] The court believed it would be difficult to adequately resolve the issue of fraud because the seller was not a party to the action. Justice Megarry

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117. *Id.* at 320.

118. The credit was made through a second bank, which sent instructions to a third French bank to open an irrevocable credit with a fourth bank. The seller placed the goods with a carrier and the buyer's account was debited for the contract price. The funds were then placed in a joint account of the first bank and the buyer. *Id.* at 316-17.

119. Out of ninety-four cartons, two were empty, five were filled with rubbish or packing, twenty-five record boxes and three cassette boxes were only partially filled, and two boxes labelled as cassettes were filled with records. The buyer received only 518 of the 825 cassettes specified in the underlying contract, and 75% of the 518 cassettes delivered were nonconforming. Only 12 different records were sent instead of the 112 different records required by the sales contract, and of 8,625 records ordered, only 275 were in compliance with the contract. The serial numbers on the shipping cartons had been changed, seemingly to comply with the contract order, and the serial numbers of the records inside had been pasted over with semitransparent material. *Id.* at 317-18.

120. The buyer also attempted to enjoin payment of any sum to any other party pursuant to the letter of credit. *See id.* at 318-19.

121. *Id.* at 320.

122. *Id.* at 319.

123. *Id.*

concluded that "accordingly, the matter has to be dealt with on the footing that this is a case in which fraud is alleged but has not been established."[124] Second, the *Discount* court stated that judicial interference should not be invoked in this type of commercial transaction unless there was a showing of sufficiently grave cause.[125] The court reasoned that without a showing of grave cause a plaintiff should be required to pursue its claim in contract based on proof of a contractual breach in the underlying commercial transaction.[126]

In two subsequent cases, English courts reaffirmed *Discount* and denied injunctive relief.[127] In *Harbottle v. National Westminster Bank,*[128] the court adopted the reasoning of *Sztejn,* but stated that a buyer must establish either a clear case of fraud or other exceptional circumstances in order to enjoin a bank's payment on its irrevocable obligation.[129] In its final analysis, the court ruled that "[t]he present case is a long way from *[Sztejn]* and also much weaker on its facts than the *Discount Records* case."[130] In *Edward Owen Ltd. v. Barclays Bank*[131] the court acknowledged that the issuing bank's strict obligation to pay under a confirmed irrevocable letter of credit was the established doctrine,[132] but recognized the *Sztejn* exception when the bank had knowledge of fraud in the underlying transaction:[133]

> [I]f the documents are presented by the beneficiary himself, and are forged or fraudulent, the bank is entitled to refuse payment if it finds out before payment, and is entitled to recover the money as

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124. *Id.*

125. *Id.* at 320.

126. In addition, the court reasoned that as a result of the intricacies in the instant transaction, *see supra* note 118, the bill of exchange may have already passed to a holder in due course, and if so, the *Sztejn* doctrine clearly would not apply. [1975] 1 W.L.R. at 319-20.

127. Harbottle Ltd. v. National Westminster Bank, [1977] W.L.R. 752 (Q.B.); Edward Owen Ltd. v. Barclays Bank, [1977] 3 W.L.R. 764 (C.A.). In both cases the *ex parte* injunctions obtained by the respective buyers were discharged. *See* Ellinger, *Fraud in Documentary Credit Transaction,* 1981 J. Bus. L. 258.

128. [1977] 3 W.L.R. 752 (Q.B.).

129. *Id.* at 762.

130. *Id.*

131. [1977] 3 W.L.R. 764 (C.A.).

132. *Id.* at 771.

133. *Id.* at 771-72.

paid under a mistake of fact if it finds out after payment.[134]

On the facts of *Edward Owen*, however, the Court of Appeal held that the requirements of the *Sztejn* fraud exception had not been met, and payment could not be enjoined.[135]

The preceding English cases typify the difficulty courts have had in determining the parameters of clear fraud in letter of credit transactions. Undoubtedly, in order to apply the *Sztejn* exception, a plaintiff must be able to present compelling evidence of fraud.[136] The House of Lords in *United City Merchants Ltd. v. Royal Bank of Canada*,[137] shed some light on the parameters of the *Sztejn* fraud exception in English courts. In *U.C.M.*, the seller and its assignee brought suit against the confirming bank, Royal Bank of Canada, for payment under an irrevocable, transferable letter of credit. Vitro, a Peruvian company, had contracted with the seller to purchase equipment for use in the manufacture of glass fiber and had arranged for the purchase to be financed by a letter of credit. Under the terms of the sales contract, the seller was to ship the equipment from London to Peru on a specified date. In fact, the goods were shipped a day late and from Felixstowe, not London. The carriers, however, fraudulently altered the bills of lading to show that the shipment had occurred on the specified date and from London as required in the letter of credit instructions. Neither the seller nor its assignee knew of the fraudulent alteration when the assignee presented the documents to the confirming bank for payment. The confirming bank learned of the fraudulent alteration, rejected the documents, and refused to pay on the letter of credit. On the letter of credit issue, the High Court found for the seller and assignee,[138] but was subsequently

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134. *Id.* at 772 (quoting Browne, J., in the unreported case of first impression, Bank Russo-Iran v. Gordon, Woodroffe & Co. Ltd., The Times (London), Oct. 4, 1972).

135. *Id.* at 774, 776, 777.

136. As one commentator observed, in *Discount*, even though the buyer opened some of the goods in the presence of one of the defendants, the court still found no compelling evidence of fraud. *See* Goode, *Reflections on Letters of Credit-1*, 1980 J. Bus. L. 291.

137. [1982] 2 W.L.R. 1039 (H.L.); *see* 1982 J. Bus. L. 319.

138. [1979] 1 Lloyd's L.R. 267, 278 (Q.B.); *see* 1979 J. Bus. L. 268. In addition to the letter of credit issue, the case dealt with the legality of the contract in light of article VIII section 2(b) of the Bretton Woods Agreements Order in Council of 1946.

reversed by the Court of Appeal.[139] On appeal the House of Lords reversed the Court of Appeal and restored the decision of the High Court.[140] The House of Lords reasoned that while the *Sztejn* fraud exception was recognized by the law of the United Kingdom its application should be limited to cases in which the fraud was committed by a presenting seller and should not be extended to every situation in which the issuing or confirming bank gains knowledge of the underlying fraud.[141]

V. Judicial Approaches to Fraud in Letter of Credit Transactions

The burden of establishing the existence of fraud in letter of credit transactions rests upon the party alleging fraud. Courts that have adopted *Sztejn* have applied various standards of proof in determining when the burden of persuasion has been discharged.[142] Because a unilateral claim of fraud would be insubstantial,[143] the party alleging fraud must establish both that the fraud existed under the appropriate standard of proof, and that the bank had notice of the fraud.[144] Courts in the United Kingdom require the party alleging fraud to show a sufficiently grave cause to justify a finding of fraud,[145] and courts in both the United States and the United Kingdom recognize the defense of a holder in due course status.[146]

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139. [1981] 3 W.L.R. 242 (C.A.); *see* 1981 J. Bus. L. 221, 381.

140. [1982] 2 W.L.R. 1039, 1049 (H.L.).

141. *Id.* at 1045-46.

142. Standards that have been used include an irrebuttable presumption, *Sztejn*, 177 Misc. 719, 721, 31 N.Y.S.2d 631, 633 (Sup. Ct. 1941), and a preponderance of the factual evidence, *Dynamics*, 356 F. Supp. 991, 998 (N.D. Ga. 1973).

143. *See Discount* [1975] 1 W.L.R. 315, 319 (Ch.).

144. *See e.g., Sztejn*, 177 Misc. 719, 722, 31 N.Y.S.2d 631, 634 (Sup. Ct. 1941). The *Sztejn* court found that the issuing bank had received notice of the seller's active fraud before it either accepted or made payment on the seller's draft.

145. *See e.g., Discount*, [1975] 1 W.L.R. 315, 320 (Ch.).

146. *Sztejn*, 177 Misc. at 723, 31 N.Y.S.2d at 635. In *Sztejn*, the court emphasized that the issuing bank acted as a seller's agent for collection, not as a holder in due course. The court pointed out, however, that if the bank presenting the draft is a holder in due course, its claim for payment could prevail notwithstanding any fraud in the underlying transaction. This position of the *Sztejn* court has been reiterated elsewhere. *See* Banco Espanol de Credito v. State St. Bank and Trust, 409 F.2d 711 (1st Cir. 1969); *see also* Annot., 35 ALR

Courts that have not relied on the *Sztejn* fraud exception often use other theories to distinguish the type of fraud involved in *Sztejn.*[147] When a seller resorts to the type of egregious fraud in the underlying transaction that leaves the buyer and, thus, the issuing bank little or nothing of value, the goals of preventing fraud and protecting innocent parties justify allowing an issuing bank to refuse to honor a draft even when presented with conforming documents.[148]

Courts generally analyze fraud in letter of credit transactions in one of three ways: (1) the "unqualified liability" approach, (2) the *Sztejn* fraud exception approach, or (3) the UCC approach. The approach adopted by a court is significant to the banks because the determination of a bank's liability for actions taken after the bank receives notice of alleged fraud differs under each approach. A confirming bank has three alternatives when potentially fraudulent documents have been presented. The bank can honor the draft, refuse to honor the draft, or seek to have payment of the draft enjoined. The consequences to the bank of each alternative will be analyzed with respect to the three judicial approaches for dealing with fraud in letter of credit transactions.

A. The Unqualified Liability Approach

Under the "unqualified liability" approach espoused in the Uniform Customs and Practices for Documentary Credits (UCP)[149] and followed in *U.C.M. v. Royal Bank of Canada,*[150] an

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3d 1397; UCC § 5-114(1), (2)(a) and (b); United Bank v. Cambridge Sporting Goods, 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976); *Discount* [1975] 1 W.L.R. 315.

147. *See* W. Va. Housing Dev. Fund v. Sroka, 415 F. Supp. 1107 (W.D. Pa. 1976).

148. This refusal is valid when the buyer and issuing bank are left with "trash rather than treasure." Harfield, *Identity Crises in Letter of Credit Law,* 24 ARIZ. L. REV. 239, 245 (1982); *see also* Harfield, *Enjoining Letters of Credit Transactions,* 95 BANKING L.J. 596, 603 (1978); Megrah, *Risk Aspects of the Irrevocable Documentary Credit,* 24 ARIZ. L. REV. 255, 258 (1982).

149. *See* Schmitthoff, *The New Uniform Customs for Letters of Credit,* EXPORT 18 (May 1983). The ICC has standardized banking practices concerning documentary credits by formulating the UCP. Professor Schmitthoff has observed that the international organization has been very successful and its efforts have achieved global effect. C. SCHMITTHOFF, *supra* note 1, at 246. According to the author, the UCP had been adopted by banks and banking associations in 175 countries and territories by March 1974. *Id.*

150. [1982] 2 W.L.R. 1039. *See supra* text accompanying notes 26-31.

issuing or confirming bank *must pay* on a draft when presented with conforming documents because in letter of credit transactions the bank is considered to deal in documents and not in goods.[151] If the bank receives notice of the alleged fraud, and is later presented with conforming documents, the bank may still honor the draft without liability. In fact, if the bank refuses to honor the draft, it will be liable to the seller because its responsibility is limited to an examination of the specified documents for conformity. The UCP does not provide for judicial injunction of payment.

The UCP clearly provides that neither the issuing nor confirming bank has a duty to investigate a claim of fraud.[152] The documents received by the bank, however, are evidence that goods have been shipped. In addition, limiting the bank's duties to a documentary inquiry reduces the bank's cost of credit and, thus, the rates charged to its customers because the bank serves as a conduit for funds but does not get involved in disputes between the buyer and seller.

Prior to *Sztejn*, United States common law recognized that a bilateral agreement between the parties could displace the general rule of separation.[153] A letter of credit could incorporate the terms of the underlying sales contract and require the issuing bank to examine the quality and conformity of the goods shipped, as well as to inspect the documents. Where the letter of credit does not incorporate the underlying contract, the buyer is considered to have made a deliberate choice to instruct the issuing bank to adhere to an "unqualified obligation." The "unqualified liabil-

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151. Even though the UCP applies to letter of credit transactions, the buyer may also be able to stop payment if egregious fraud can be established under UCC § 5-114. *See* United Bank v. Cambridge Sporting Goods, 392 N.Y.S.2d 265, 41 N.Y.2d 254, 360 N.E.2d 943 (1976).

152. *See* UCP art. 8, *supra* note 68. UCP art. 9 provides: "Banks assume no liability or responsibility for the form, sufficiency, *accuracy, genuineness, falsification or legal effect of any documents.*" (emphasis added). *Id.*; *see also* Gian Singh & Co. v. Banque de L'Indochine [1974] 1 W.L.R. 1234, cited with approval by Lord Diplock in *U.C.M.*, [1982] 2 W.L.R. 1039, 1046.

153. *Sztejn*, 177 Misc. at 721, 31 N.Y.S.2d at 633-34. "If the buyer and the seller intended the bank to [go behind the documents and examine the goods] they could have so provided in the letter of credit itself. . . ." *Id.* The summary of facts in *Sztejn* does not indicate, nor does it seem likely, that the letter of credit issued by the bank contained such terms because the court emphasized the fraudulent activity of the seller. *Id.* at 721-22, 31 N.Y.S.2d at 634.

ity" approach may, however, be overly formalistic.[154] It is discussed simply for purposes of theoretical completeness and does not represent the law in any domestic or international jurisdiction.[155]

B. The *Sztejn* Fraud Exception

The "*Sztejn* fraud exception" provides that the issuing bank may refuse to honor the draft if the seller or his agent fraudulently presents to the conforming bank documents that expressly or impliedly contain material misrepresentations of fact, and the issuing bank learns of the fraud before the draft is presented. According to this approach, the "principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller."[156] If the issuing bank has knowledge of the fraud and honors the draft, the bank will be liable to the buyer unless it can establish that it was acting in good faith within the requirements of UCC section 5-114(2)(b), or unless the presenter was a holder in due course.[157] On the other hand, if the bank refuses to honor the draft, the bank would only be liable if the draft was presented by a holder in due course.[158]

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154. This formalism would not evade the eye of equity. *See* (in another context) Parkin v. Thorold (1852), 16 Beav. 59, 66-67:

> . . .Courts of Equity make a distinction in all cases between that which is [a] matter of *substance* and that which is [a] matter of *form*; and if it find[s], that by insisting on the *form*, the *substance* will be defeated, it holds it to be *inequitable* to allow a person to insist on such form, and thereby defeat the substance. *Id.*(emphasis added).

155. *See supra* notes 83, 107 and accompanying text; *see also* B. KOZOLCHYK, *supra* note 1 at 528-31; Stoufflet, *Payment and Transfer in Documentary Letters of Credit: Interaction Between the French General Law of Obligations and the Uniform Customs and Practice*, 24 ARIZ. L. REV. 267, 272-73 (1982). The House of Lords in England is the highest court in the Anglo-American common law system to consider the issue and to categorically reject the unqualified liability approach. The court declared, "[t]o this general statement of principle [the unqualified liability approach] as to the contractual obligations of the confirming bank to the seller, there is one established exception: [the *Sztejn* fraud exception]." *U.C.M.*, [1982] 2 W.L.R. 1039, 1045.

156. *Sztejn*, 177 Misc. at 722, 31 N.Y.S.2d at 634.

157. *See supra* note 146. The seller in these circumstances could *not* enjoy the status of holder in due course. *See* Geva, *Contractual Defenses as Claims to the Instrument: The Right to Block Payment on a Banker's Instrument*, 58 OR. L. REV. 283, 296 (1979).

158. The UCC requirement of good faith would also be applicable under these circumstances. UCC § 5-114(2)(b).

The *Sztejn* fraud exception typically enables the buyer to enjoin payment to the fraudulent seller in a letter of credit transaction.[159]

Although the fraud exception was first articulated by Justice Shientag in the *Sztejn* decision, it is based upon well-founded common law concepts. A leading jurist and practitioner in the law of letters of credit has noted that "[o]f crucial importance, however, is that Justice Shientag invented no novel concepts, but rather affirmed, after scholarly review, the judicial endorsement of commercial practice. Indeed, his opinion should be read *as a limitation on judicial interference with the performance of a letter of credit.*"[160] The *Sztejn* fraud exception requires an initial determination as to the appropriateness of judicial interference. The crucial factor in determining the propriety of any judicial interference is whether or not the fraud is material enough to negate the confirming or issuing bank's obligation to pay upon presentation of the documents. The House of Lords in *U.C.M.* described the focus of the Court of Appeal as whether "any of the documents presented under the credit by the seller/beneficiary contain[ed] a material misrepresentation of fact that was *false to the knowledge of the person who issued the document* and intended by him to deceive persons into whose hands the document might come."[161] If the documents presented by the seller contain a material misrepresentation, and those documents were knowingly issued with the intent to deceive, the bank's obligation to pay is negated and an injunction can properly be ordered.[162] The English Court of Appeal explicitly extended the fraud exception set forth in *U.C.M.* to include:

> "[s]ituations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer by [sic] served." [The fraud exception] should also be applied to any fraud which, if known to the issuing or confirming bank, would en-

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159. It must be remembered, however, that if a presenter other than the seller is a holder in due course, or if the bank acts in bad faith, the court will not block payment by granting an injunction.

160. Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 603 (1978) (emphasis added).

161. [1982] 2 W.L.R. 1039, 1048 (This "half-way house" approach, which Lord Diplock criticizes, was used by the English Court of Appeal in reaching its decision in *U.C.M.*, [1981] 3 W.L.R. 242).

162. *See U.C.M.*, [1981] 3 W.L.R. 242, 269.

> title it to refuse payment. . . . So here the defendants [the issuing or confirming bank], when they knew . . . that they had been intentionally deceived as to a date material to their liability to pay, *were right to refuse to honour the plaintiff's credit.* Even though the judge was not able to find that [the person who intentionally made the misrepresentation] was the plaintiff's agent in making the bill of lading for presentation to the defendants. . . .[163]

The application of the fraud exception by the Court of Appeal in *U.C.M.* is a perfect example of the judicial interference against which Harfield warns.[164] The noted legal scholar C. M. Schmitthoff, however, loathes the proposition that a confirming or issuing bank must pay the seller when the documents presented were fraudulently issued by someone other than the seller and the bank was aware of the fraud.[165] The proper question, however, is not whether payment should be made, but whether the seller of the documents should be paid. The answer to that question depends upon characterizing a letter of credit transaction as a sale of documents. The fundamental doctrine of separation in letter of credit transactions stands for the proposition that absent any definite involvement in the actual fraud by the seller, the confirming bank is obligated to purchase the documents from the seller, and the seller is obligated to sell them to the confirming bank "as is," barring any personal representations to the contrary.[166] The "half-way house" approach articulated in *U.C.M.*[167] employs an

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163. *Id.* at 269-70 (citation omitted) (emphasis added).

164. *See supra* text accompanying note 160.

165. "I prefer the well-reasoned judgment of the Court of Appeal [U.C.M. v. Royal Bank of Canada [1981] 3 W.L.R. 242], according to which the confirming bank need not honour the credit once fraud is established, irrespective of *what kind* of fraud it is and *who* committed the fraud." Schmitthoff, *A Great Case on Letters of Credit*, EXPORT 3, 4 (July-Aug. 1982) (emphasis added). "It would be desirable that the next revision of the [UCP] . . . should expressly authorise banks to refuse honouring a credit if fraud is established, *irrespective* of whether it is further proved that the seller or other beneficiary is a party to the fraud." Schmitthoff, *Export Trade: Fraud in Documentary Credit Transactions; Obligation of Bank to Pay with Knowledge of Fraud*, 1982 J. BUS. L. 321 (emphasis added).

166. *See* Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 614 (1978); Harfield, *Identity Crises in Letter of Credit Law*, 24 ARIZ. L. REV. 239, 242-43 (1982). *See also* H. GUTTERIDGE & M. MEGRAH, THE LAW OF BANKERS' COMMERCIAL CREDITS 137-45 (6th ed. 1979); C. SCHMITTHOFF, *supra* note 1, at 269.

167. *See supra* note 161 and accompanying text.

"objective fraud" standard to deny payment to the seller if there were any fraudulent misrepresentations in the credit documents, regardless of whether the seller has been implicated in the fraud. One commentator has asserted that "[t]he potential for mischief lies in improper extrapolation from [*Sztejn*] rather than in application of the [fraud exception] rationale,"[168] and cites the "half-way house" approach as an example.[169]

In *U.C.M.*, the House of Lords explicitly rejected the "half-way house" approach through a strict reading of the court's rationale in the *Sztejn* holding.[170] The focus of the House of Lords in *U.C.M.* was not whether the seller knew of an inherent lie within the documents, but whether the lie contained in the documents had consciously been made by the seller.[171] The House of Lords narrowed the fraud exception previously articulated by the Court of Appeal: "[t]here is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that *to his knowledge* are untrue."[172]

Because the seller in *U.C.M.* was unaware of the inaccuracy in the bill of lading, the fraudulent acts of the shippers did not fall within the House of Lords' fraud exception. The fraud exception seems to be limited to those "[s]ituations of fraud in which the wrongdoing of the [seller] has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served."[173]

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168. *See* Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 614 (1978).

169. *See* Harfield, *Identity Crises in Letter of Credit Law*, 24 ARIZ. L. REV. 239, 242-43. In *Sztejn*, Justice Shientag was concerned with preventing the "unscrupulous seller" from obtaining shelter under the umbrella of the fundamental doctrine of separation in letter of credit transactions. In *U.C.M.*, [1982] 2 W.L.R. 1039, the seller was not unscrupulous, but on the contrary, was in fact a victim of the fraud.

170. *U.C.M.*, [1982] 2 W.L.R. 1039, 1048-49. In *U.C.M.*, the seller was not unscrupulous: "the sellers [were] unaware of the inaccuracy . . . of the date at which the goods were actually on board. . . . They believed that it was true and that the goods had actually been loaded . . . as required by the documentary credit." *Id.* at 1045.

171. *Id.* at 1048-49.

172. *Id.* at 1045 (emphasis added).

173. Intraworld Indus. v. Girard Trust Bank, 461 Pa. 343, 359, 336 A.2d 316, 324-25 (1975).

C. The UCC Approach Under Article 5

UCC section 5-114(2)(b) empowers a confirming or issuing bank to either honor or dishonor a draft that is presented with fraudulent documents.[174] As discussed above, if the bank in good faith honors a draft after receiving notice of an alleged fraud in the underlying transaction, the bank is not liable. A bank may properly refuse to honor a draft except when the presenter is a holder in due course[175] or the seller's behavior was not "unscrupulous."[176] In either of the latter two circumstances, the bank is liable to the seller. In addition, a court may enjoin the bank from honoring the seller's draft if the fraud exception requirements under UCC section 5-114(2)(b) are met.

One commentator has categorized the problems of section 5-114(2) as "definitional and structural."[177] The terms "forged," "fraudulent," and "fraud in the transaction" are neither defined in the text of the UCC nor elaborated upon in the comments.[178] The Court of Appeal decision in *U.C.M.* discussed the common law *Sztejn* fraud exception and distinguished the terms "forged" and "fraudulent"[179] as the difference:

> [b]etween a document which was inaccurate and a document which was false, or between a document which was false to the knowledge of its maker and a document which he forged. . . . A document may tell a lie about itself, e.g., about the person who made it, or the time or place of making. If it tells a lie about the maker, it is a forgery; if it tells a lie about the time or place of making "where either is material," it is a forgery . . . . In the former case it may be a nullity, in the latter not . . . . Or the document may tell a lie about its contents. Then it is no forgery, but the maker or utterer of it may commit . . . some kind of fraud. Or a document may be untrue in the sense of inaccurate by mistake and without any in-

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174. UCC § 5-114(2)(b).

175. *See supra* note 159. Notice of fraud, however, deprives correspondent banks of holder in due course status. *See* United Bank Ltd. v. Cambridge Sporting Goods, 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976).

176. *See Sztejn*, 177 Misc. at 722, 31 N.Y.S.2d at 634; *see also* W. Va. Housing Dev. Fund v. Sroka, 415 F. Supp. 1107 (W.D. Pa. 1976); New York Life Ins. v. Hartford Nat'l Bank & Trust, 173 Conn. 492, 378 A.2d 562 (1977).

177. Note, *Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114*, 63 MINN. L. REV. 487, 497 (1979).

178. *See* J. WHITE & R. SUMMERS, *supra* note 108, at 736.

179. *U.C.M.*, [1981] 3 W.L.R. 242, 262.

tention to deceive by its maker or anyone who puts it forward.[180]

The House of Lords limited application of the *Sztejn* fraud exception in English courts to intentional behavior, including forgeries or fraudulent acts by the seller and acts done with the seller's knowledge or implied acquiescence.[181]

The definitions of "forgery" and "fraudulent" articulated in cases decided under the UCC are often disparate and incorporate both common law and equity principles.[182] The UCC, however, fails to indicate whether a bank's refusal to honor a draft is justified only when the fraudulent acts were performed by, or with the implied acquiescence of, the seller, or whether a bank's refusal is also justified when the fraudulent acts were committed by persons independent of the seller acting without his knowledge. The "half-way house" approach that was rejected by the House of Lords in *U.C.M.*, therefore, may satisfy the UCC section 5-114(2) "forgery" and "fraudulent" definitions:

> [I]f any of the documents presented under the credit by the seller/beneficiary contain a material misrepresentation of fact that was *false to the knowledge of the person who issued the document* and intended by him to deceive persons into whose hands the document might come, the confirming bank is under no liability to honour the credit, even though, as in the instant case, the persons whom the issuer of the document intended to, and did, deceive included the seller/beneficiary himself.[183]

This interpretation would clearly extend the definitions of "forgery" and "fraudulent" for purposes of UCC section 5-114(2) beyond the common law *Sztejn* fraud exception.

The meaning "fraud in the transaction" in section 5-114(2) is also troublesome. If the term refers to fraud in documentary transactions,[184] then it is arguably redundant because that definition merely restates the "forged" and "fraudulent" terms.[185] If, however, the term refers to fraud in the underlying transaction,[186]

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180. *Id.* (citations omitted).

181. *U.C.M.*, [1982] 2 W.L.R. 1039, 1048-49.

182. *See* Note, *supra* note 177, at 498-500 and the cases cited therein.

183. [1982] 2 W.L.R. 1039, 1048.

184. This interpretation is consistent with the "narrow definition" referred to in Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 602 (1978).

185. *See* Note, *supra* note 177, at 502.

186. White and Summers support this expansive reading of fraud:

then it is undeniably a statutory abrogation of the fundamental doctrine of separation,[187] and could open a Pandora's box of uncertainty concerning the continued viability of that doctrine in letter of credit transactions.[188] Both *Sztejn* and *Intraworld Industries, Inc. v. Girard Trust Bank*[189] support the abrogation of the fundamental doctrine of separation, and justify a finding of "fraud in the transaction," or in the underlying transaction, if the deliberate acts of a seller have caused the complete failure of performance in the underlying contract. [190]

Section 5-114(2)(b), Official Comment 2, provides that the issuing bank may voluntarily dishonor a letter of credit.[191] If the issu-

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> In NMC Enterprises, Inc. v. Columbia Broadcasting System, Inc. [14 UCC 1427 (N.Y. Sup. Ct. 1974)] . . . [t]he beneficiary argued that the fraud must be "intrinsic to the documents" and not merely "as to the sales contract." The judge said *this distinction is specious, and we agree (although in our earlier edition we suggested the contrary might be the law).* The facts of this case illustrate a type of "fraud in the transaction" . . . independent of forgery or fraud in the documents (footnote in brackets).

White & Summers, *supra* note 108, at 737 (emphasis added).

187. The doctrine of separation is also referred to as the doctrine of "abstraction." *See* B. KOZOLCHYK, INTERNATIONAL ENCYCLOPEDIA, *supra* note 1, at 71.

188. The formulation of "fraud in the transaction" of section 5-114 that defines "transaction" as "so intimately related" to the independent letter of credit contract *as to be an implied term of that contract,*" in Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 606 (1978) (emphasis added) is particularly transparent. The factual contexts of individual letter of credit disputes can still blur such distinctions. *See* Note, *supra* note 177, at 505.

189. 461 Pa. 343, 336 A.2d 316 (1975).

190. Such findings must be limited to fact situations that are amenable to such stark, concrete determinations. "When the beneficiary has *intentionally shipped no goods at all* . . . the predicate of the independence of the issuer's engagement [is] removed." Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 360, 336 A.2d 316, 325 (1975) (emphasis added). "Yet, the distinction between some goods and none is unavoidably subjective." *Id.*

191. Professor Schmitthoff has advocated empowering the issuing or confirming bank to voluntarily dishonor the credit through a new provision to be included in the next revision of the UCP. *See supra* note 165. Another commentator has made the inverse, antithetical proposal of "[e]liminating the issuer's right of elective dishonor in cases in which the customer *alleges* fraud. . . ." *See* Note, *supra* note 177, at 510 (emphasis added). The elimination of the voluntary dishonor "would tend to increase commercial utility of letters of credit." *Id.* Professor Schmitthoff bases his proposition on the *establishment* of fraud by the buyer whereas the Note only requires the buyer to make an *allegation* of fraud. Even though an issuing or confirming bank will require substantive guidance when the information is received, both propositions presumably are based on the bank's independent judgment.

ing bank voluntarily dishonors a draft, the *seller* is forced into court to bring suit against the bank and bears the burden of proof. Requiring the seller to prove lack of fraud is fair because the seller typically has the best access to the facts at issue. Three factors argue against allowing the bank to exercise voluntary dishonor. First, as a practical matter, the provision for voluntary dishonor appears to permit the bank or the buyer to circumvent the formidable hurdles involved in obtaining a court injunction restraining payment.[192] Second, the power of voluntary dishonor carries a risk of abuse.[193] Although a buyer may have agreed to indemnify the bank in the event that a court finds the bank's voluntary dishonor to be wrongful, in the meantime, the bank's voluntary dishonor could have destroyed the seller's security of payment.[194] The third and most persuasive argument against voluntary dishonor is that banks ordinarily do not have sufficient resources to properly evaluate the factual assertions made by bank customers.[195] Banks simply cannot be expected to perform the role of a court by evaluating all the available facts in accordance with the rules of evidence, and properly determine which party is legally right.[196]

Because the UCC does not explicitly limit the instances in which dishonors are justified to those situations in which the *seller* has committed the fraud, the UCC fraud exception appears to be broader than the *Sztejn* fraud exception. The UCC may be interpreted as justifying voluntary dishonor when there has been objective fraud in the transaction,[197] even in the absence of the seller's involvement. Of course, the UCC grants the issuer the choice of honoring or dishonoring the credit,[198] regardless of whether another party is attempting to invoke the fraud exception. The only restrictions on the issuer are the UCC's good faith

192. *See* Harfield, *Enjoining Letter of Credit Transactions,* 95 BANKING L. J. 596, 612-14 (1978). Some commentators have criticized the issuing or confirming bank's ability to circumvent the court injunction procedure and voluntarily dishonor a credit under UCC 5-114(2)(b). *See* Note, *supra* note 177, at 510, 513.

193. *See* Note, *supra* note 177, at 510, 513. It is the author's opinion that this type of abuse should be proved empirically *before* an attempt is made to eliminate banks' power to voluntarily dishonor.

194. *Id.*

195. *Id.* at 513.

196. *See id.*

197. *See supra* note 186.

198. *See supra* text accompanying note 112.

requirement, and the possibility of an injunction enjoining the honor.[199] The wide latitude granted to banks is reasonable because the good faith requirement obviates the need for a bank to determine the facts[200] and then assume the risk for that determination.

VI. CONCLUSION

The *Sztejn* principles present to issuing banks a perplexing dilemma in international letter of credit transactions. Issuing banks that have received notice of fraud in the underlying transaction may yet be presented with documents that apparently conform to the letter of credit requirements by a seller who is not a holder in due course. If the bank refuses payment and a court determines that the fraud was not sufficiently egregious, the bank will be liable for breach of contract between the bank and the seller. But if the bank relies on the doctrine of separation and pays the draft, and a court later determines that the fraud was egregious, the bank could be faced with liability to the buyer and a virtually worthless right of recovery[201] from the fraudulent seller. Under *Sztejn*, therefore, a bank may be forced to investigate any allegations of fraud in order to avoid liability arising from a breach of contract. To require issuing banks to conduct an investigation of all allegations of fraud in letter of credit transactions will place an undue burden on banks that will probably hamper international trade by increasing the cost of credit. The potential risk is that every allegation of fraud could either delay payment because of the investigation demands or lead to litigation that may significantly diminish a seller's certainty of payment. As a consequence, a very important consideration in international letter of credit transactions would be the real possibility of being forced to litigate in a foreign arena.

The primary advantage of the *Sztejn* approach, protection of the buyer against fraud in the transaction, is also provided by the UCC approach. In addition, the UCC provides enhanced and specific protection for those banks in the domestic setting.[202] Under the UCC, the issuing bank still risks breaching the letter of credit contract with the seller if a court finds that its refusal to pay on

199. *Id.*
200. *See* Note, *supra* note 177, at 513.
201. *See* Edward Owen Ltd. v. Barclay's Bank, [1977] 3 W.L.R. 764, 771-72.
202. *See* UCC § 5-114(3).

the draft was based on less than egregious fraud.[203] An issuing bank acting in good faith, however, may always play it safe and honor the draft despite any allegations of fraud. In short, the UCC approach reduces the risk to issuing banks and the need to investigate allegations of fraud in domestic transactions as well as reducing the risk and investigation required under the *Sztejn* approach in the international arena. Although the seller's certainty of payment is also reduced under the UCC approach, certainty of payment is not as potent a deterrent to domestic trade as it is in international transactions. Both the UCC approach and the *Sztejn* fraud exception contain a value judgment that the enhanced protection of the buyer against fraud commensurately offsets the directly proportional atrophy of the seller's security of payment.

In contrast, the unqualified liability approach of the UCP forces the buyer to assume the risk of fraud (in the absence of protective provisions in the letter of credit), ensures the sellers' certainty of payment, and simplifies and reduces the cost of credit to the banks. The UCP approach to risk-allocation encourages international trade more than any other approach and, thus, may be preferable in international transactions. Because domestic trade does not present the seller with the risk of litigating disputes in a foreign forum, the domestic buyer is afforded greater protection than its international counterpart without discouraging the seller or placing an undue burden on the banks. The UCC approach, by contrast, affords greater protection to the buyer, and seems to present the best approach for regulating domestic transactions. Whether the UCC approach should be utilized in international trade depends upon an analysis of the empirical deterrent effect that the UCC provisions would have on international trade. If, under the UCC, a bank is in good faith able to honor a draft that is presented with conforming documents, even after notification of fraud in the transaction, the deterrent effect on international trade may be insignificant. Furthermore, the UCC approach would not place too onerous a burden on banks unless acting in good faith was interpreted to require the bank to investigate allegations of fraud. Requiring the bank to investigate

203. The bank, however, should be able either to *indemnify* the buyer if it acted on its own initiative and committed an error of judgment or to sue successfully on an *indemnity from* the buyer if the bank acted in breach pursuant to instructions from the buyer.

allegations of fraud, or determining that the UCC had a significantly detrimental effect on international trade, would justify embracing *Sztejn* as neither imposing too large a cost for protecting the buyer, nor subjecting banks to the dilemma of deciding whether to honor drafts, when the banks are aware of fraud in the underlying transactions.