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Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114

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Note: Letters of Credit: Injunction As A Remedy For Fraud In U.C.C. Section 5-114

I. INTRODUCTION

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

The basic letter of credit arrangement involves three parties: the issuer, the customer, and the beneficiary.[5] These parties are engaged

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1. Letters of credit have played a major role in the financing of trade in goods, at least since the twelfth century, and perhaps as far back as the time of the Phoenicians, Babylonians, Assyrians, and Greeks. Wiley, *How to Use Letters of Credit in Financing the Sale of Goods,* 20 BUS. LAW. 495 (1965). In recent years, as much as ninety percent of the United States' merchandise imports have been financed by letters of credit. W. HAWKLAND, 2 A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 791 (1964); Annot., 35 A.L.R.3d 1404, 1407 (1971). In the last few decades, inventive financiers have adapted letters of credit to a large variety of domestic transactions as well. Harfield, *The Increasing Domestic Use of the Letter of Credit,* 4 U.C.C. L.J. 251, 252 (1972).

2. The forms that a letter of credit can take are as varied as the transactions to which it is adapted. In addition to basic sales contracts, letters of credit are now used as adjuncts to construction contracts, corporate consolidations, and the issuance of commercial paper. They are also in current use instead of, or in connection with, bid and performance bonds, escrow accounts, stock transfers and purchases, and leases of real and personal property. Even the common charge card has been said to be no more than a plastic letter of credit. Harfield, *supra* note 1, at 252.

3. *See generally* H. HARFIELD, BANK CREDITS AND ACCEPTANCES 27 (5th ed. 1974); B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS 9, 599 (1966). The Uniform Commercial Code defines the letter of credit as "an engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit . . . ." U.C.C. § 5-103(1)(a).

For earlier common law definitions of letters of credit, see Second Nat'l Bank v. M. Samuel & Sons, Inc., 12 F.2d 963, 966 (2d Cir. 1926); Border Nat'l Bank v. American Nat'l Bank, 282 F. 73, 77 (5th Cir. 1922); Lafargue v. Harrison, 70 Cal. 380, 383-84, 9 P. 259, 261 (1885); Liggett v. Levy, 233 Mo. 590, 598, 136 S.W. 299, 301 (1911).

4. The commission is usually one-eighth of one percent of the amount of the draft. Annot., *supra* note 1, at 1406.

5. These three principal parties are defined by the Code as follows:

(c) An "issuer" is a bank or other person issuing a credit.

(d) A "beneficiary" of a credit is a person who is entitled under its terms to draw or demand payment.

. . . .

in three contractual relationships.[6] First, there is the "underlying contract," the business agreement between the customer and the beneficiary. Usually, this contract contains, in addition to the substantive terms concerning the sale of goods or the rendering of services, a description of the agreed upon letter of credit arrangement. Second, there is a contract between the issuing bank and its customer, whereby the bank agrees to issue the letter of credit to the beneficiary and the customer agrees to reimburse the bank for the amount paid out under the credit plus a commission. Finally, there is the letter of credit itself,[7] an agreement between the issuer and the beneficiary in which the bank promises to honor the beneficiary's drafts if they are accompanied by certain documents specified in the credit.[8]

Basic to the law of letters of credit is the rule of independent contracts.[9] The credit contract between the issuer and the beneficiary

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> (g) A "customer" is a buyer or other person who causes an issuer to issue a credit. The term also includes a bank which procures issuance or confirmation on behalf of that bank's customer.

U.C.C. § 5-103(1).

Often, however, there will be more than one bank involved in a letter of credit transaction. Section 5-103(1) defines two of the most common ancillary parties to the basic tripartite agreement:

> (e) An "advising bank" is a bank which gives notification of the issuance of a credit by another bank.
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> (f) A "confirming bank" is a bank which engages either that it will itself honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank.

Id. § 5-103(1). *See also* H. HARFIELD, *supra* note 3, at 33-38; B. KOZOLCHYK, *supra* note 3, at 12-13. When referring to parties in a letter of credit transaction, this Note will conform to the U.C.C. definitions.

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

7. *But see* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-2 (1972) (because beneficiary does not enter into any agreement directly with issuer, letter of credit itself is not, strictly speaking, a contract). *See also* H. HARFIELD, *supra* note 3, at 51-55.

8. Aside from the draft or demand for payment, the documents required under a letter of credit vary greatly because their form and content are determined by the business context in which the credit is used. A commercial credit will ordinarily require the beneficiary to present bills of lading (or other documents of title), invoices, or insurance papers. J. WHITE & R. SUMMERS, *supra* note 7, § 18-1, at 604 n.9. Where appropriate, a commercial credit may also require presentment of consular invoices, certificates of weight or quality, and an export or import license. *See* H. HARFIELD, *supra* note 3, at 56-57. *See also* note 41 *infra*.

Some letters of credit require no documentation and allow the beneficiary to draw simply upon presentment of a draft. *See* H. HARFIELD, *supra* note 3, at 56-57. The use of these so-called "clean" credits has been increasing significantly in the 1970s. *Id.* at 56 n.2. *See generally* U.C.C. § 5-102, Official Comment 1.

9. *See, e.g.*, Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464-65 (2d

is viewed by the law as separate and independent from the underlying business transaction between the customer and the beneficiary.[10] The issuer is under a legal duty to honor demands for payment that comply with the terms of the credit, without reference to the beneficiary's performance of the underlying contract.

For the beneficiary contemplating a complex sales or service transaction, especially one carried on over long distances, across international boundaries, or with an unfamiliar party, the letter of credit is an attractive commercial device for two reasons. First, the beneficiary, who would otherwise have only the customer's assertions of solvency and good faith as assurance of payment, may rely on the financial responsibility of an issuing bank.[11] Second, since the rule of independent contracts requires the issuer to honor the beneficiary's drafts upon presentment of requisite documents regardless of the customer's claims of defective performance of the underlying contract, the beneficiary may be assured of payment without equivocation if the terms and conditions of the credit are met.[12] Any claims of defective performance raised by the customer must be settled after payment by suit on the underlying contract.[13]

The letter of credit offers a degree of certainty for which parties to a complex transaction can bargain—certainty without which the parties may not be able to transact business at all.[14] The letter of credit is, in effect, a contractual allocation of risk between the customer and the beneficiary.[15] By requiring use of a letter of credit, the

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Cir. 1970); American Steel Co. v. Irving Nat'l Bank, 266 F. 41, 43-44 (2d Cir. 1920); Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 441, 96 N.Y.S.2d 779, 787 (Sup. Ct. 1949); Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 722, 31 N.Y.S.2d 631, 633-34 (Sup. Ct. 1941); Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 357, 336 A.2d 316, 323 (1975).

10. *See* cases cited in note 9 *supra*. *See also* H. HARFIELD, *supra* note 3, at 31-32.

11. "The essence of the instrument is that it adds the credit of the bank to the credit of the buyer." H. HARFIELD, *supra* note 3, at 27. *See, e.g.*, Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464 (2d Cir. 1970); Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 357, 336 A.2d 316, 323 (1975).

12. The letter of credit also offers a degree of certainty from the customer's point of view. The customer is assured that payment under the credit will take place only when the beneficiary complies with the terms of the credit as specified in the customer's instructions to the issuing bank. In transactions in which the beneficiary is required to present documents of title under a commercial credit, *see* note 8 *supra*, this allows the customer to defer payment for the goods until they are delivered. *See generally* Note, *Documentary Letters of Credit and the Uniform Customs and Practice for Documentary Credits (1974 Revision): A Selective Analysis*, 3 J. CORP. L. 147, 148-51 (1977).

13. *See* J. WHITE & R. SUMMERS, *supra* note 7, § 18-7, at 630-31.

14. *See generally* B. KOZOLCHYK, *supra* note 3, at 11-12; Justice, *Letters of Credit: Expectations and Frustrations* (pt. 1), 94 BANKING L.J. 424, 427-30 (1977); Note, *supra* note 12, at 147-51.

15. *See* Harfield, *supra* note 1, at 257-58; Justice, *supra* note 14, at 427-30.

beneficiary may greatly reduce his risk of not being paid. But certainty of payment for the beneficiary is risk of loss for the customer.[16] Since the rule of independent contracts requires the issuer to honor the drafts of the beneficiary despite defective performance of the underlying contract, the customer will be without a remedy if, for some reason, he is unable to make himself whole by suit on that contract.[17]

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

Faced with the harsh results that the rule of independent contracts could produce in these kinds of cases, some courts have concluded that the rule should not protect a fraudulent beneficiary.[18]

16. The degree of risk to the customer, like the degree of certainty to the beneficiary, is a matter of bargaining between those two parties. If the letter of credit requires the beneficiary to present extensive documentation evidencing the performance of his obligations when presenting drafts for payment, the customer exposes himself to relatively little risk in entering the letter of credit agreement. The less evidence required, the greater risk undertaken. Justice, *supra* note 14 at 429-30. *See* note 8 *supra* & note 35 *infra*. *See also* J. WHITE & R. SUMMERS, *supra* note 7, § 18-7, at 631 (noting the advantage of third-party certification of performance).

17. A customer's legal remedy for breach of the underlying contract may be ineffectual for several reasons, but the most common is the impending insolvency of either the customer or the beneficiary. The nearly insolvent customer may be faced with bankruptcy if he has to reimburse the issuer without receiving the anticipated benefits of the underlying contract. *See, e.g.*, Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973); NMC Enterprises, Inc. v. Columbia Broadcasting Sys., Inc., 14 U.C.C. Rep. 1427, 1429 (N.Y. Sup. Ct. 1974). And, of course, an action on the underlying contract may be fruitless if the beneficiary is insolvent at the time of payment or becomes insolvent after disposing of the proceeds of the credit. *See, e.g.*, Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172, 181-82 (Minn. 1977).

In international transactions, an action on the contract often must be litigated in the beneficiary's country. Carrying on international litigation may be prohibitively expensive. *See* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (taking judicial notice of the burden of carrying on international litigation).

18. *See, e.g.*, Old Colony Trust Co. v. Lawyers' Title & Trust Co., 297 F. 152, 158 (2d Cir.), *cert. denied*, 265 U.S. 585 (1924); Banco Tornquist, S.A. v. American Bank & Trust Co., 71 Misc. 2d 874, 875, 337 N.Y.S.2d 489, 490 (Sup. Ct. 1972); Balbo Oil Corp. v. Zigourakis, 40 Misc. 2d 710, 711, 243 N.Y.S.2d 806, 807 (Sup. Ct. 1963); Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 441-42, 96 N.Y.S.2d 779, 790 (Sup. Ct. 1949); Asbury Park & Ocean Grove Bank v. Nat'l City Bank, 35 N.Y.S.2d 985, 988-89 (Sup. Ct. 1942), *aff'd mem.*, 268 A.D. 984, 52 N.Y.S.2d 583

But judicial efforts to balance the commercial utility of letters of credit against the desire to prevent the unjust enrichment of a defrauding beneficiary have been unsatisfactory as well as inconsistent. Case law prior to the adoption of the Uniform Commercial Code was unclear. Section 5-114 of the Code,[19] in attempting to resolve the vagaries in the common law, appears merely to have codified them.

Through analysis of both pre-Code and post-Code cases and a fresh look at the countervailing policies underlying the law of letters of credit, this Note attempts to justify a new balance between commercial utility and the prevention of unjust enrichment. It suggests a narrow and well demarcated exception to the rule of independent contracts that will serve the general purpose of commercial utility while providing a remedy for victims of intentional fraud in letter of credit transactions. Finally, this Note proposes a revision of Code section 5-114 embodying the suggested exception.

II. FRAUD AND THE RULE OF INDEPENDENT CONRACTS

A. The *Sztejn* Case

In the context of an ordinary breach of the underlying contract by the beneficiary, the rule of independent contracts is supportable on the ground that the customer has accepted the risk that payment may be made despite some defects in the beneficiary's performance.[20] If the rule were not observed and payment were not made, the parties' expectations and allocations of risk would be upset. Beneficiaries would soon cease to view letters of credit as means of rapid, guaranteed payment, and their commercial utility would be lost.[21]

As the degree and the *mala fides* of the beneficiary's breach increase to the point of fraud, however, this rationale becomes less persuasive. A number of pre-Code cases thus recognized that a court of equity could enjoin an issuer from honoring a credit, even though the beneficiary had presented documents that technically conformed to its terms, when allowing honor would defraud the customer.[22]

The landmark case is *Sztejn v. J. Henry Schroder Banking*

(1944); Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 722, 31 N.Y.S.2d 631, 634-35 (Sup. Ct. 1941); Higgins v. Steinhardter, 106 Misc. 168, 169, 175 N.Y.S. 279, 280 (Sup. Ct. 1919).

19. U.C.C. § 5-114.

20. *See, e.g.*, Cal. U. Com. Code § 5114, California Code Comment 6 (West 1964). *See also* Harfield, *supra* note 1, at 257-58.

21. *See, e.g.*, Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 721, 31 N.Y.S.2d 631, 633 (Sup. Ct. 1941); Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 357-59, 336 A.2d 316, 323 (1975).

22. *See* cases cited in note 18 *supra*.

Corp.[23] The plaintiff there was a New York merchant who had contracted to purchase a quantity of bristles from a supplier in India. In order to pay for the bristles, the plaintiff also contracted with the defendant bank for the issuance of an irrevocable commercial letter of credit[24] in favor of the supplier. After placing fifty cases of material on board a steamship, the supplier presented a draft, along with the requisite documents, to the defendant bank for payment. Before the bank paid the draft, however, the customer brought an action to enjoin payment. The complaint alleged that the beneficiary had filled the cases with cowhair and other worthless material with the intent of defrauding the plaintiff. The bank moved to dismiss the complaint on the ground that it failed to state facts sufficient to constitute a cause of action. In considering the motion, the court reaffirmed that a letter of credit is independent of the underlying contract of sale between the beneficiary and the customer, but went on to hold,

> Of course, the application of this doctrine presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of the letter of credit. . . .
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> However, . . . a different situation is presented in the instant action. This is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous beneficiary.[25]

The *Sztejn* case thus appeared to set out an exception to the rule of independent contracts for cases in which the underlying transaction was tainted by beneficiary fraud. As later cases showed, however, the holding of *Sztejn* was less than clear.[26]

23. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

24. An "irrevocable" letter of credit is one in which the issuing bank's obligation cannot be cancelled or altered unilaterally. The "revocable" credit is one in which the bank's obligation to pay may be modified or cancelled at any time, without notice to the beneficiary. Obviously, the beneficiary's certainty of enforcing the bank's promise in the case of a "revocable" credit is virtually nonexistent until the moment of actual payment by the bank. *See* H. HARFIELD, *supra* note 3, at 40-42; B. KOZOLCHYK, *supra* note 3, at 19-21. Because of its limited appeal to risk-averse beneficiaries, the "revocable" letter of credit is very rarely, if ever, used in modern commercial transactions. *See* H. HARFIELD, *supra* note 3, at 41.

25. 177 Misc. at 721-22, 31 N.Y.S.2d at 634.

26. *See* notes 47-56, 66-73 & 103-04 *infra* and accompanying text.

B. SECTION 5-114

The law pertaining to letters of credit has now been codified in article 5 of the Code.[27] The problem of fraud and the doctrine of independent contracts is dealt with in section 5-114,[28] which sets out the issuer's duty to honor drafts presented under the letter of credit agreement. This section reads, in pertinent part, as follows:

> (1) An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. . . .
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> (2) Unless otherwise agreed when documents appear on their face to comply with the terms of credit but a required document. . . is forged or fraudulent or there is fraud in the transaction
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> (a) the issuer must honor the draft or demand for payment if honor is demanded by . . . a holder in due course . . . ; and
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> (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.[29]

Subsection (1) of section 5-114 is a restatement of the common law rule of independent contracts, setting forth the basic principle that the credit contract must be carried out regardless of the quality of the beneficiary's performance of the underlying transaction.[30]

Subsection (2) outlines the issuer's duty to honor upon present-

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27. U.C.C. §§ 5-101 to -117. The special character of article 5 is noteworthy. It is not a complete "code" like articles 2 and 3, which deal with sales and commercial paper respectively. R. ANDERSON, THE UNIFORM COMMERCIAL CODE § 5-101:3 (2d ed. 1971). Instead, the article is intended to set up an "independent theoretical framework for the further development of letters of credit." U.C.C. § 5-101, Official Comment. The drafters felt that no statute could effectively or wisely codify the law of letters of credit without hampering development of the device. *See* U.C.C. § 5-102, Official Comment 2. Hence, in section 5-102(3), they "ma[de] explicit a court's power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so." *Id.* The Official Comment goes on to say that article 5 is to be applied in accord with the canon of liberal interpretation (U.C.C. § 1-102(1)), so as to promote the underlying purposes and policies of the article. *Id.*

28. U.C.C. § 5-114.

29. *Id.* § 5-114(1),(2).

30.
> The letter of credit is essentially a contract between the issuer and the beneficiary and is recognized by this Article as independent of the underlying contract between the customer and the beneficiary . . . . In view of this independent nature of the letter of credit engagement, the issuer is under a duty to honor the drafts or demands for payment which in fact comply with the terms of credit without reference to their compliance with the terms of the underlying contract.

U.C.C. § 5-114, Official Comment 1.

ment of documents in the special case in which required documents are forged or fraudulent, or there is fraud in the transaction. When these conditions exist the section divides presenters into two classes. Under subsection (2)(a), if the presenter of the draft is the equivalent of a holder in due course, the general rule of independent contracts applies and the issuer must honor the draft or demand for payment. Under subsection (2)(b), however, if the presenter is anything but a holder in due course, the bank is not *obligated* to honor. It *may* honor despite notification from the customer of fraud, forgery, or other defect not apparent on the face of the documents; and the Official Comment makes it clear that the issuer in a subsection (2)(b) situation may also choose not to honor, either by its own volition or when requested to do so by the customer.[31] If the subsection (2)(b) conditions exist, and the issuer refuses to dishonor the drafts as requested by the customer, the customer may seek recourse in a court. Section 5-114 may be said, therefore, to allow two sorts of dishonor under the letter of credit: elective dishonor where an issuer chooses to comply with a customer's request, and injunctive dishonor ordered by a court.

C. FRAUD IN COMMERCIAL AND STANDBY LETTERS OF CREDIT

In general, letters of credit are used in one of two ways: either as a mechanism of payment or as a guaranty. When used as a payment mechanism they are denominated commercial letters of credit.[32] When used as guaranties they are called standby letters of credit.[33]

In the typical commercial credit situation, a buyer (customer) who has entered into a contract for the purchase of goods makes arrangements with his bank (issuer) for the issuance of a letter of credit in favor of his seller (beneficiary). By such a credit, the seller receives payment for the goods upon presentment to the bank of drafts and specified documents.[34]

In a typical standby credit situation, involving construction financing, for example, a developer (customer) contracts with a construction company (beneficiary) to build an apartment complex. The construction company wants assurance that it will be paid in full upon completion of the apartments and, therefore, insists that the developer obtain from a bank (issuer) a letter of credit that will make payment available in the event the developer should default.[35]

31. *Id.* at Official Comment 2.

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

33. *Id.* at 278.

34. Commercial credits are almost always "documentary" rather than "clean" credits. B. KOZOLCHYK, *supra* note 3, at 33 & n.54. *See* note 8, *supra* & note 41, *infra*.

35. Conversely, the developer may hear that the construction company has failed

Both the commercial and the more recently developed standby letters of credit are covered by article 5 of the Code.[36] While the Code recognizes both types, none of the sections in article 5, including section 5-114, distinguish between them in any way. An issuer is thus under the same duty to honor demands for payment under a standby credit as under a commercial credit.[37]

Although the issuer's duty as defined by section 5-114 may be the same in the case of both kinds of letters of credit, its inclinations may be quite different. A commercial credit, as has already been noted, is an agreed upon mechanism of payment in a sales transaction. All parties to the transaction fully expect that it will be drawn upon, and presentment of drafts by the beneficiary indicates nothing more than that the underlying transaction appears to be following its intended course.[38] When a beneficiary presents drafts under a commercial credit, therefore, the issuer will usually pay immediately without consulting its customer.[39]

On the other hand, since a standby credit operates as a guaranty, the issuer's expectation is that it will not be drawn upon in the normal course of events.[40] When drafts are presented under a standby credit, the issuer has good reason to suspect that there has been a serious breakdown in relations between the parties to the underlying transaction. The effect of such notice of problems in the underlying transaction is to make the issuer reluctant to honor the drafts. If the bank's customer has refused to pay the beneficiary because of defects in the beneficiary's performance and the bank honors the draft, the bank may be forced to sue its customer to obtain reimbursement. This is obviously undesirable, especially if the customer is important to the bank. Alternatively, if the customer's failure to pay the benefi-

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to complete a number of building projects. He therefore may require the construction company to secure a letter of credit in his favor, providing liquidated damages in the event of a default in performance. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 722 (1973).

Documents required to be presented under a standby letter of credit normally consist of only a draft accompanied by documents in which the beneficiary certifies nonperformance by the customer of his obligations under the underlying contract. Arnold & Bransilver, *supra* note 32, at 279; Note, *Guaranty Letters of Credit: Problems and Possibilities*, 16 ARIZ. L. REV. 822, 827 (1974). Standby credits may also be "clean" credits. *See* note 8 *supra*.

36. *See* U.C.C. § 5-102, Official Comment 1.

37. *See* notes 27-31 *supra* and accompanying text.

38. Arnold & Bransilver, *supra* note 32, at 277-78.

39. Telephone interview with Jeffrey Judy, Manager, Letter of Credit Area, Northwestern National Bank, Minneapolis (Nov. 27, 1978) [hereinafter cited as Judy Interview]; Telephone interview with Ronald Smith, Second Vice-President, Chase Manhattan Bank, New York City (Nov. 27, 1978) [hereinafter cited as Smith Interview].

40. *See* Arnold & Bransilver, *supra* note 32, at 277-78.

ciary was the result of the customer's insolvency, the issuer may never be reimbursed even if the claim is litigated.[41] Hence, it is the current practice of issuers to contact the customer and investigate the circumstances of the transaction upon presentment under a standby credit.[42]

With these differences in mind, at least one generalization can be made in regard to section 5-114 and the problem of fraud in the underlying transaction. The issuer that is in a position to exercise an elective dishonor under subsection (2)(b) will be more inclined to do so in the case of the standby credit than in the case of the commercial credit. A standby issuer is therefore more likely to search for grounds for elective dishonor and to comply with its customer's request not to pay on the beneficiary's drafts.

Since standby credits are subject to the same provision as commercial credits, however, issuers have the same duty to honor under both types of credits.[43] Standby issuers are thus forced to honor drafts in many situations in which it is not in their best interest to do so. As a result, issuers have come under considerable criticism for imprudent involvement in standby credits.[44]

The differences between the two uses of letters of credit are important mainly to the issuer in determining whether to commit itself in credit contracts in the first place. It is up to the issuer to make full

41. A commercial letter of credit usually requires the beneficiary to present documents of title to the goods being sold to the issuer upon presentment for payment. In case of the customer's insolvency, these documents provide the issuing bank with an immediate security interest of some value. The issuer's risk under such a credit is comparable to that of a secured loan. Verkuil, *supra* note 35, at 721.

Under guaranty letters of credit the issuer does not receive security upon payment to the beneficiary. The issuer's only resort is an action against its customer, a party that has already defaulted on its principal obligation. From a credit risk point of view, therefore, the standby credit is far more likely to result in loss to the issuer than the commercial credit. *Id.* at 727-28.

42. Judy Interview, *supra* note 39; Smith Interview, *supra* note 39.

It should be noted that U.C.C. § 5-112 provides that a bank at which a documentary draft or demand for payment has been presented under a credit may, "without dishonor" of the draft or demand, defer honor until the close of the third banking day following receipt of the documents. U.C.C. § 5-112(1)(a).

43. *See* notes 36-37 *supra* and accompanying text.

44. Commentators have suggested that most issuers have a fundamental misunderstanding of the sort of risk they are taking by engaging themselves in standby credits. *See* Harfield, *supra* note 1, at 258-59; Verkuil, *supra* note 35, at 737.

In the past, it has also been argued that banks are acting ultra vires when they issue standby credits, and that transactions involving them can be declared unenforceable. Verkuil, *supra* note 35, at 724-27. *See* B. KOZOLCHYK, *supra* note 3, at 629-35. It has also been suggested that standby credits should be included within the lending limits of issuing banks in order to ensure their solvency. Verkuil, *supra* note 34, at 739. *See also* Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697 (1975).

assessment of the relative risks of entering into a commercial or standby credit.[45]

III. PROBLEMS IN THE POST-CODE CASES: THE PROGENY OF *SZTEJN* AND SECTION 5-114

Section 5-114 is often referred to by courts and commentators as a codification of the *Sztejn* case.[46] Such statements are acccurate inasmuch as *Sztejn* and section 5-114 appear to set forth a fraud exception to the rule of independent contracts. They are also accurate inasmuch as section 5-114 does nothing to clear up several questions left unanswered by *Sztejn*. For purposes of discussion in the context of section 5-114, the problems can be categorized as definitional and structural.

A. DEFINITIONAL PROBLEMS IN SECTION 5-114

Section 5-114 allows dishonor of drafts presented under a letter of credit when the documents presented are "forged" or "fraudulent," or when there is "fraud in the transaction." But neither the Code itself nor its official comments define these terms or explain the differences between them. This omission by the Code drafters has resulted in uncertainty as to the proper standard of fraud, and also as to the bounds of the "transaction" that can properly be examined in determining the existence of the fraud.

1. *The Standard of Fraud*

Courts considering the term "fraud" in the context of section 5-114 are divided over the degree of beneficiary malfeasance that must be shown by a party seeking to prevent honor of a letter of credit. Little guidance on this question can be had from *Sztejn*. Due to its procedural posture, the case was decided on the most extreme facts. The defendant bank had moved to dismiss the complaint for failure to state a cause of action. The court therefore had to assume that the

45. *See* Harfield, *supra* note 1, at 258-59; Verkuil, *supra* note 35, at 739. Commentators are in general agreement that if parties use letters of credit as a guaranty mechanism, they should still be subject to the rigors of the strict rule of independent contracts so as not to infect the commercial utility of letters of credit with any new ambiguities. *See* Harfield, *supra* note 1, at 258-59. *See also* B. KOZOLCHYK, *supra* note 3, at 633-34.

46. *See, e.g.*, Edgewater Constr. Co. v. Percy Wilson Mortgage & Fin. Corp., 44 Ill. App. 3d 220, 233, 357 N.E.2d 1307, 1318 (1976) (concurring opinion); United Bank, Ltd. v. Cambridge Sporting Goods Corp., 41 N.Y.2d 254, 259, 392 N.Y.S.2d 265, 270 (1976). *See also* B. CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS 92 (Cum. Supp. No. 1, 1978); Justice, *Letters of Credit: Expectations and Frustrations* (pt. 2), 94 BANKING L.J. 493, 496 (1977). *But see* Harfield, *Enjoining Letter of Credit Transactions,* 95 BANKING L.J. 596, 605 (1978).

allegations of the plaintiff customer were true: that the beneficiary had intentionally engaged in a scheme to defraud the customer totally.[47]

In subsequent cases, various attempts have been made to define the sort of fraud necessary to allow dishonor. In *West Virginia Housing v. Sroka Development Fund,*[48] the court asserted,

> Neither the Code nor its comments give any hint as to what type of fraud gives the bank an option to pay or not to pay under this section. . . . While the courts have been reluctant to define fraud, it generally is thought to include an element of *intentional misrepresentation* in order to profit from another.[49]

A contrary position was espoused in *Dynamics Corp. of America v. Citizens & Southern National Bank:*[50]

> Fraud has a broader meaning in equity [than at law] . . . and *intention to defraud or misrepresent is not a necessary element.*
>
> Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.[51]

Yet a third standard was announced in *United Bank Ltd. v. Cambridge Sporting Goods:*[52]

> [T]he drafters of section 5-114 . . . in utilizing the term "fraud in the transaction," have eschewed a dogmatic approach and adopted a *flexible standard* to be applied as the circumstances of a particular situation mandate. It can be difficult to draw a precise line between cases involving breach of warranty (or a difference of opinion as to the quality of goods) and outright fraudulent practice on the part of the seller.[53]

It is probably unwise to attempt to articulate a comprehensive definition of fraud, since those inclined to fraudulent practices would soon find loopholes in the definition.[54] Still, given the elusiveness of

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47. 177 Misc. at 721, 31 N.Y.S.2d at 633.

48. 415 F. Supp. 1107 (W.D. Penn. 1976).

49. *Id.* at 1114 (emphasis added). *See also* NMC Enterprises, Inc. v. Columbia Broadcasting Sys., 14 U.C.C. Rep. 1427, 1429 (N.Y. Sup. Ct. 1974) ("[W]here no innocent third parties are involved and where the documents or the underlying transaction are tainted with intentional fraud . . . the court may grant injunctive relief restraining . . . honor.").

50. 356 F. Supp. 991 (N.D. Ga. 1973).

51. *Id.* at 998 (emphasis added) (quoting S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193-94 (1963) quotation of W. DEFUNIAK, HANDBOOK OF MODERN EQUITY 235 (2d ed. 1956)).

52. 41 N.Y.2d 254, 392 N.Y.S.2d 265 (1976).

53. *Id.* at 260-61, 392 N.Y.S.2d at 271 (emphasis added).

54. *See* Stonemets v. Head, 248 Mo. 243, 263, 154 S.W. 108, 114 (1913):

the concept,[55] it seems equally unwise to use the term without attempting to define it, especially in a statute that must strike a delicate balance between the need to preserve the commercial utility of the letter and the need to prevent unjust enrichment of the beneficiary. Ideally, the standard of fraud should define a degree of malfeasance on the part of the beneficiary beyond which the application of risk allocation and commercial utility rationale should not be carried.[56]

Of the cases mentioned above, one—*Dynamics Corp.*[57]—is clearly a step in the wrong direction. The broad, equitable standard of fraud described in that case would appear to sanction injunctive relief in cases where the beneficiary's behavior might be more properly characterized as defective performance. Widespread adoption of this rule could lead to the use of section 5-114 as a device for litigating breach of contract, a result that would quickly destroy the utility of the letter of credit altogether. Also, as discussed above,[58] the reasonableness of the risk-allocation concept varies inversely with the culpability of the beneficiary's actions. It is clear that the standard of fraud enunciated in *Dynamics Corp.* extends well into the range where it is *reasonable* to deny the customer an injunction on the ground that he voluntarily assumed the risk of being left without an effective remedy for defects in the beneficiary's performance.

The two other cases, *Sroka*[59] and *United Bank*,[60] represent a movement toward the ideal. The *Sroka* concept of "intentional misrepresentation"[61] is an attempt to define the kind of malfeasance

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> Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard-and-fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition. . . . [D]efinitions of fraud are of set purpose left general and flexible, and thereto courts match their astuteness against the versatile inventions of fraud-doers.

See also Green, *Deceit*, 16 VA. L. REV. 749 (1930).

55. Prosser notes that liability for fraud may be based on intent to deceive, negligence, or strict liability:

> There has been a good deal of overlapping of theories, and no little confusion, which has been increased by the indiscriminate use of the word "fraud," a term so vague that it requires definition in nearly every case. Further difficulty has been added by a failure to distinguish the requisites of the action in tort at law from those of equitable remedies, and to distinguish the different forms of misrepresentation from one another, and misrepresentation itself from mere mistake.

W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 684-85 (4th ed. 1971) (footnotes omitted).

56. *See* notes 14-17 *supra* and accompanying text.

57. *See* notes 50-51 *supra* and accompanying text.

58. *See generally* text accompanying notes 20-26 *supra.*

59. *See* note 49 *supra* and accompanying text.

60. *See* note 53 *supra* and accompanying text.

61. 415 F. Supp. at 1114. *See* note 49 *supra* and accompanying text.

that should be required. The *United Bank* court, despite its nominal adherence to a "flexible standard," draws attention to the *degree* of malfeasance by indicating that the line must be drawn somewhere between "breach of warranty . . . and outright fraudulent practice."[62] Read together, the cases set a standard requiring a showing of intent combined with some degree of defective performance. What remains unclear is the point at which the degree of intentionally defective performance is sufficient to warrant an injunction.

It is impossible, of course, to formulate a general rule of absolute precision, but an admirable attempt was made in *Intraworld Industries, Inc. v. Girard Trust Bank,*[63] where the court held,

> In light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit, we think that the circumstances which will justify an injunction against honor must be *narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.* A court of equity has the limited duty of "guaranteeing that [the beneficiary] not be allowed to take unconscientious advantage of the situation and run off with plaintiff's money on a *pro forma* declaration which has absolutely no basis in fact."[64]

This somewhat disparate case law suggests that some degree of intent is required, that breach of contract is beyond the scope of section 5-114, and that breach shades into fraud in the "narrowly limited" situation where "the legitimate purposes of the independence of the issuer's obligation would no longer be served." A synthesis of the case law remains somewhat vague, however, and in order to assure a proper balancing of commercial utility and protection from fraud, it should perhaps be made clear that the Code contemplates a strict standard of fraud akin to the common law tort action of deceit.[65]

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62. 41 N.Y.2d at 261; 392 N.Y.S.2d at 271. *See* note 53 *supra* and accompanying text.

63. 461 Pa. 343, 336 A.2d 316 (1975).

64. *Id.* at 359, 336 A.2d at 324-25 (emphasis added) (quoting Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 999 (N.D. Ga. 1973)).

65. "[T]he tort action of deceit requires something in the way of knowledge of the falsity of the statement and an intention to mislead, while the contract action on a warranty does not." W. PROSSER, *supra* note 49, § 105, at 685. The elements of the tort cause of action in deceit have been stated as follows:

> 1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.
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> 2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element often is given the technical name of "scienter."
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> 3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.

2. *Fraud in the "Transaction"*

Section 5-114 does not make clear whether the phrase "fraud in the transaction" refers to fraud in the transaction as a whole, encompassing the underlying contract, or whether it refers strictly to fraud in the letter of credit contract between the issuer and beneficiary.[66] Looking to the *Sztejn* case for clarification is again not particularly helpful since it is amenable to both the broad and the narrow reading of "transaction." On one hand, the court noted that "the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous [beneficiary]."[67] In addition, Justice Shientag stated,

> Although our courts have used broad language to the effect that a letter of credit is independent of the primary contract between the buyer and seller, that language was used in cases concerning alleged breaches of warranty; no case has been brought to my attention on this point involving an intentional fraud on the part of the seller. . . ."[68]

These passages would seem to indicate that *Sztejn* was announcing a rather broad exception to the rule of independent contracts under which a court of equity, presented with a customer's request for an injunction on grounds of fraud, may examine the underlying contract and compare the beneficiary's performance with his obligations thereunder, regardless of the form and contents of the documents presented under the credit.

On the other hand, the court in *Sztejn* also stated that the application of the doctrine of independent contracts "presupposes that the documents accompanying the draft are genuine and conform in terms to the requirement of the letter of credit."[69] Relying on this language, courts and commentators have been in general accord that *Sztejn* is authority only for the proposition that a document which falsifies the facts it purports to represent, in order to cover up a beneficiary's fraud, is a nonconforming document.[70]

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4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.

5. Damage to the plaintiff, resulting from such reliance.

Id. at 685-86 (footnotes omitted). *See also* J. WHITE & R. SUMMERS, *supra* note 7, § 9-1; Harfield, *supra* note 46, at 614-15.

66. *See* Harfield, *supra* note 46, at 605.

67. 177 Misc. at 721-22, 31 N.Y.S.2d at 634.

68. *Id.* at 722, 31 N.Y.S.2d at 634.

69. *Id.* at 721, 31 N.Y.S.2d at 634.

70. An illustration of this narrow reading is found in Merchants Corp. v. Chase Manhattan Bank, 5 U.C.C. Rep. 196 (N.Y. Sup. Ct. 1968). There, the beneficiary presented documents under the letter of credit contract showing that goods were placed on board a ship in Korea not later than January 31, 1968. In fact, the goods were not loaded until February 13. Citing *Sztejn,* the court determined that the plaintiff cus-

Under this narrow interpretation of *Sztejn,* a court presented with a request for an injunction may only examine the documents tendered under the letter of credit contract and determine whether the assertions made by the beneficiary therein are true or false.[71] Of course, if the documents make assertions about performance of the underlying contract, the court must look to the beneficiary's actual performance to determine whether the documents are accurate.[72] In *Sztejn,* for example, the documents presented stated that fifty crates of bristles had been delivered.[73] Only by looking at the beneficiary's performance of the underlying contract could the court ascertain that the fifty crates did not contain bristles.

The language of section 5-114 would appear to provide a broader exception to the rule of independent contracts than the "fraud-represented-in-the-documents" exception generally attributed to *Sztejn.* Section 5-114 allows dishonor not only when a "document . . . is forged or fraudulent," but also when "there is fraud in the transaction."[74] On its face, this additional language would seem to provide for cases of beneficiary fraud where there are no fraudulent documents; otherwise the "fraud in the transaction" language would be nugatory.[75] Under this broad reading of section 5-114, courts and issuers would be allowed to look directly to the underlying transaction upon a customer's allegations of fraud. Their scrutiny of the underlying transaction would not be limited by the precise scope of the representations made in the presented documents. The beneficiary's performance of the underlying contract would simply be compared with his obligations under that agreement to determine whether his demand for payment constitutes fraud.

Those commentators espousing the narrow view of *Sztejn,* how-

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tomer was entitled to injunctive relief because his dispute with the beneficiary was "not as to warranty or breach of the contract between the buyer and seller but as to the *terms of the letter of credit,* the independent contract between the [beneficiary] and the issuer." *Id.* at 197 (emphasis added). *See, e.g.,* Pringle-Associated Mortgage Corp. v. Southern Nat'l Bank, 571 F.2d 871, 874 (5th Cir. 1978); Bossier Bank & Trust Co. v. Union Planter's Nat'l Bank, 550 F.2d 1077 (6th Cir. 1977); CNA Mortgage Investors, Ltd. v. Hamilton Nat'l Bank, 540 S.W.2d 238, 243 (Tenn. Ct. App. 1975); Harfield, *supra* note 46 at 605; Verkuil, *supra* note 35, at 720 n.23.

71. *See* Verkuil, *supra* note 35, at 720 n.23.

72. *See* B. KOZOLCHYK, *supra* note 3, at 464.

73. 177 Misc. at 721, 31 N.Y.S.2d at 633.

74. U.C.C. § 5-114(2).

75. *See* Edgewater Constr. Co. Inc. v. Percy Wilson Mortgage & Fin. Corp., 44 Ill. App. 3d 220, 233, 357 N.E.2d 1307, 1317-18 (1976) (Jiganti, J., concurring) ("Uniform Commercial Code Section 5-114(2)(b) . . . says essentially that even though the relationship [between the issuer and the beneficiary] is independent of [the] underlying contract, the court will still look at that very contract if there is fraud, forgery or other defect.").

ever, have adopted a congruently narrow view of section 5-114.[76] This construction of section 5-114 allows dishonor only where the fraud is represented in the letter of credit contract by falsified documents. To these commentators, the phrase "fraud in the transaction" means fraud in the letter of credit contract only, and is a redundant rephrasing of "forged or fraudulent" documents.[77]

Where documents fraudulently describe the beneficiary's performance of the underlying transaction, dishonor would be allowed under both the narrow view and the broad view. The distinction between the narrow and broad views is important, however, in cases in which the fraud in the transaction is no longer represented by false statements in the documents. For example, if the document presented in the *Sztejn* case had required the beneficiary to state only that "fifty crates" had been delivered, there could be no fraud found under the narrow view because there was no fraud in the documents themselves: they stated that fifty crates had been shipped and that much was true.[78] To take another example, in a "clean" credit there is no documentation accompanying the drafts presented.[79] Under the narrow view, these credits could never be dishonored since there is no possible fraudulent documentation.[80]

Applying the broad view of *Sztejn* and section 5-114, drafts presented under either the hypothetical "fifty crates" credit or the clean credit could be dishonored. Under that approach, a court or issuing bank would simply compare the beneficiary's performance of the

76. *See, e.g.*, Harfield, *supra* note 46, at 605-06; Verkuil, *supra* note 35, at 720 n.23.

77. Thus, while asserting that the phrase "fraud in the transaction" in § 5-114 adds a "new gene" to the *Sztejn* fraud doctrine Henry Harfield would construe that language to mean fraud in a transaction "so intimately related to the independent letter of credit contract as to be an implied term of that contract." Harfield, *supra* note 46, at 605-06. Harfield, therefore, reaffirms the basic narrow view of *Sztejn*: the fraud must be expressly or impliedly represented in the documents of the credit contract in order for the beneficiary's drafts to be dishonored. The "so intimately related . . . as to be an implied term" standard is rather vague and it is not clear whether it would result in the inclusion of more transactions than would the strict reading of *Sztejn*.

78. It is unclear what the result would be if the "so intimately related . . . as to be an implied term" test proposed by Henry Harfield were applied to the hypothetical case. *See* note 77 *supra* and accompanying text. If the description of the contents of the fifty crates as set out in the hypothetical underlying contract would be considered part of a transaction of sufficiently intimate relation, then the issuer could scrutinize the actual performance of the beneficiary and the result would be the same as under the broad view. If it were found not to be so intimately related, the beneficiary's drafts could be neither electively nor injunctively dishonored.

79. *See* note 8 *supra* and accompanying text.

80. *See, e.g.*, CNA Mortgage Investors, Ltd. v. Hamilton Nat'l Bank, 540 S.W.2d 238, 242-43 (Tenn. Ct. App. 1975). Presumably, the same result would be reached in the case of the "clean" credit under Harfield's "so intimately related . . . as to be an implied term" test. *See* notes 77-78 *supra* and accompanying text.

underlying contract with his obligations under it to determine whether his demand for payment constituted fraud.

Those espousing the narrow interpretation of *Sztejn* and section 5-114 are faced with the task of explaining why a defrauded customer should be able to prevent his loss only when the fraud is represented in the documents. Their arguments are those typically made to justify the rule of independent contracts.[81] First, the presence or absence of language in the documents incorporating terms or conditions in the underlying transaction may be seen as an allocation of risk intended by the parties.[82] If a term or condition was not incorporated, the customer accepted the risk that the beneficiary would not perform according to it. The more documentation for which the customer bargains the less risk he assumes.[83] The customer engaging a clean credit arrangement thus takes the risk of intentional fraud. Second, if courts read *Sztejn* and 5-114 broadly, and upset the expectations of the parties by reviewing the beneficiary's performance of the underlying contract, letters of credit will no longer be seen as a method of speedy, assured payment and their commercial usefulness will be lost.[84]

Both of these justifications, however, are susceptible to criticism. First, as has already been noted, the risk-allocation argument becomes somewhat less forceful as the culpability of the beneficiary's breach of the underlying contract increases.[85] It is reasonable to infer that the customer, in order to do business with a certain beneficiary, would accept limited documentation and thereby assume the foreseeable risk of some defect in the beneficiary's performance. But it is much less reasonable to infer that he would voluntarily assume the far less foreseeable risk of outright fraud. From the beneficiary's perspective, however, the risk allocation argument is considerably more convincing. It is reasonable to assume that by bargaining for a clean credit, a beneficiary is attempting to limit the necessary documentation in order to avoid any disputes over defective performance until after he has been paid.

Second, and more importantly, the arguments in favor of the narrow view, while responsive to the needs of commercial utility, are not responsive to the policy of preventing unjust enrichment.[86]

81. *See* notes 20-21 *supra* and accompanying text.

82. *See* Justice, *supra* note 14, at 427-30.

83. A customer may substantially reduce his risk by insisting, for instance, that a letter of credit in a sale of goods transaction require, in addition to the usual documentation, a certificate by a responsible third party as to the quality of the goods. *See* Harfield, *supra* note 1, at 258; Justice, *supra* note 14, at 430. *See also* notes 8 & 12 *supra* and accompanying text.

84. *See* Verkuil, *supra* note 35, at 720 n.23.

85. *See* text accompanying note 22 *supra.*

86. "[T]here is as much public interest in discouraging fraud as in encouraging

Plainly, the defrauding beneficiary is equally culpable whether or not the fraud is evidenced in the documents tendered under the letter of credit. He is being rewarded for his wrongdoing when, under the narrow view, he is allowed to collect the proceeds of the credit because the fraud is not represented in the documents.

Perhaps with the policy of preventing unjust enrichment in mind, some courts, while stating that they are following the narrow "fraud-in-the-documents-only" approach, have employed that approach in such a way that the line between it and the broad "fraud-in-the-whole-transaction" approach has become blurred. For example, in *Shaffer v. Brooklyn Park Garden Apartments,*[87] the beneficiary, attempting to collect under a standby letter of credit, presented certifications stating that the customer had failed to meet payment of authorized loans which are payable. The court ostensibly adhered to the narrow view of section 5-114: "[W]here injunctive relief is sought, the fraud alleged must be in respect to the documents presented and not as to the underlying transaction."[88] The court, however, used the language, "loans which are payable," to incorporate the underlying loan contract into the letter of credit contract. "The allegation of fraud made by [the plaintiffs] is appropriate for injunctive relief," the court said, "since it *concerns* the certifications by [the beneficiary]."[89] Injunctive relief was granted because, according to the loan contract, payment was conditioned on one of two events, neither of which occurred.

Similarly, in *NMC Enterprises, Inc. v. Columbia Broadcasting System, Inc.*[90] the beneficiary presented documents that asserted that the amounts of the drafts being drawn by him were "due and owing." Again, the court saw this language as incorporating the underlying sales contract into the letter of credit contract: "If the [underlying] contract is tainted with fraud in its inducement, then any document or signed certificate which the letter of credit requires [the beneficiary] to submit, as a condition to [the issuer's] honoring the draft, that the amount covered by the draft 'is due and owing . . .' is equally tainted."[91]

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the use of letters of credit." Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973).

87. 250 N.W.2d 172, 175 (Minn. 1977).

88. *Id.* at 180.

89. *Id.* (emphasis added).

90. 14 U.C.C. Rep. 1427 (N.Y. Sup. Ct. 1974).

91. *Id.* at 1430. The court in *NMC Enterprises* may actually have been employing the broad, fraud-in-the-whole-transaction approach. The court construed § 5-114(2)(b) to say that "[w]here no innocent third parties are involved and where the documents *or the underlying transaction* are tainted with intentional fraud, the draft need not be honored by the bank, even though documents conform on their face . . . and the court may grant injunctive relief restraining such honor . . . ." *Id.* at 1429 (emphasis added).

These courts were at least trying to maintain the appearance of following the narrow view: the documents stated that the amount was "payable" or "due and owing" when it was not. But the courts were not adhering to the underlying rationale of the narrow view—risk allocation. It is unlikely that the beneficiaries in *Shaffer* and *NMC Enterprises,* contemplated that the underlying contract was to be incorporated into the letter of credit contract when they agreed to submit documents stating that the amount drawn under the credit was "payable" or "due and owing." It seems clear that the courts in these cases were primarily concerned with preventing unjust enrichment of the beneficiary, and used the "payable" or "due and owing" language only to remain formally within the accepted method of analysis.

It remains to be seen how far courts will go in using language such as "loans which are payable" and "due and owing" as means for investigating fraud in the underlying transaction in order to prevent unjust enrichment of the beneficiary. A representation of "payment due and owing" could conceivably be implied in the presentation of drafts under any kind of credit, including a "clean" credit.[92] If this were done, of course, the distinction between the narrow and the broad views of *Sztejn* and section 5-114 would disappear entirely.

It is quite clear that adopting the broad view of *Sztejn* and section 5-114 would take a toll on the commercial utility of letters of credit.[93] It would prevent the beneficiary from allocating risk in such a way as to ensure payment prior to litigation in those cases in which a customer rightfully or wrongfully alleges intentional fraud.[94] Since

92. Courts probably would not even have to go so far as to imply such a representation out of thin air. As Harfield points out, the "clean" credit, in modern usage, almost always requires that drafts be presented with some specified writing. H. HARFIELD, *supra* note 3, at 56 n.2. Although that writing usually will not refer directly to the provisions of the underlying transaction, it may provide a sufficient foothold for a court to incorporate those terms as was done in *Shaffer* and *NMC Enterprises.*

93. *See, e.g.,* Harfield, *supra* note 46, at 605-06; Verkuil, *supra* note 35, at 720 n.23.

94. In discussing the reasons why the provision allowing injunctive dishonor was dropped entirely from the California version of § 5-114, the official commentators noted that allowing customers to seek injunctions generally defeats the purposes of risk allocation:

> [I]t is important to keep in mind the reason for the issuance of the letter of credit in the first place. It is because the seller wants assurance of being paid without equivocation, and the essence of the transaction is that it throws the risk on the buyer of pursuing the seller in his own country with any claim of breach of contract. It seems improper to destroy this basic understanding of the parties whenever the buyer raises a claim of "fraud." If the injunction is issued, then the seller must pursue the buyer in his country in a breach of

all customers who allege fraud in the underlying transaction would be allowed to seek dishonor of a beneficiary's drafts by injunction or by requesting it of the issuing bank, the number of times fraud allegations would result in delay of payment[95] or dishonor would doubtless increase. Since the beneficiary could not bargain away the risk of delay or dishonor—for example, by demanding a "clean" credit—the letter of credit would become a less attractive commercial device for wary beneficiaries.

Obviously, the problem with the broad view is not that it would prevent unjust enrichment in those cases in which the customer has a legitimate fraud claim:[96] the problem is that giving all customers the right to seek dishonor by alleging fraud would encourage unscrupulous or overanxious customers to raise specious claims that would delay payment and force the beneficiary into litigation.[97] If this abuse could be minimized, however, the broad view would be an attractive solution to the problem of fraud in the underlying transaction, preventing unjust enrichment of the beneficiary regardless of the form and content of the documents presented under the credit.

What is needed, then, is a way of limiting fraud claims that are allowed to cause a delay in payment to those claims with a basis in fact. The narrow view of *Sztejn* and section 5-114 simply limits the class of customers who can seek dishonor, through the issuer or by injunction, to those who can show fraud in the documents. By limiting the number of potential fraud claimants, the narrow view ob-

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contract action.

CAL. U. COM. CODE § 5114, California Code Comment 6 (West 1964) (quoting sixth progress report to the legislature by Senate Fact Finding Committee on Judiciary (1959-1961) Part I, the Uniform Commercial Code 494-95).

95. The delay of payment resulting from a customer's fraud allegations, even if the allegations are specious, may last from several days to several years. If a customer seeks dishonor by injunction, the beneficiary may be deprived of payment until after preliminary hearings reveal the baselessness of the customer's claim. Although such a delay would not be very long, it could do great damage to a beneficiary who has relied on timely payment. In the event that a customer seeks dishonor by the issuer, the delay may be considerably longer. The beneficiary would not be able to secure payment until he vindicated himself by a wrongful dishonor action against the issuer, *see* U.C.C. § 5-115, or an action on the underlying contract against the customer. Such litigation may delay payment for years. Moreover, the beneficiary may be forced to maintain these actions in the customer's or issuer's country.

96. It would be ridiculous, of course, to argue that a beneficiary actually bargains for the right to defraud the customer. The commercial utility argument is also inapposite in cases of actual fraud since there is no policy in favor of encouraging fraud feasors to use letters of credit as a commercial device to achieve their unscrupulous ends.

97. *See* CAL. U. COM. CODE § 5114, California Code Comment 6 (West 1964), *quoted at* note 94 *supra.* Commentators have decried the drastic effect that unbridled application of principles of equity can have on commercial utility. *See, e.g.*, Harfield, *supra* note 1, at 256-57; Justice, *supra* note 46, at 498; Verkuil, *supra* note 35, at 720 n.23; Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C. L.J. 7, 9-15 (1971).

viously reduces the total number of fraud claims made. It does not, however, limit them in a way that is specifically designed to separate valid claims from specious ones. A better method of limiting the fraud claims raised would be one that gives initial scrutiny to the validity of the claim of fraud in the underlying transaction, rather than one that merely verifies that certain terms were present in the documentation. In order to restrict the number of claims raised in a way that is responsive to equity, what is needed is a limit not on the class of customers who can seek dishonor, but on the way such dishonor may be sought.[98] Such a restriction can be effected by resolving structural problems of section 5-114.

B. Structural Problems in Section 5-114

Section 5-114(2)(b) provides that when there is "fraud in the transaction," an issuer "may" either honor the beneficiary's demand for payment,[99] or refuse to honor it.[100] If the issuer elects to honor, however, subsection (2)(b) states that a court "may enjoin such honor."[101] Thus, as previously noted, section 5-114 creates two kinds of dishonor: elective and injunctive.[102] The section makes no distinction between showings the customer must make in seeking elective or injunctive dishonor. An issuer, upon a showing by its customer that there has been "fraud in the transaction," may lawfully exercise an elective dishonor; in the alternative, upon the same showing of "fraud in the transaction" by the customer, a court may grant an injunctive dishonor.

Despite identical treatment of elective and injunctive dishonor situations on the face of section 5-114, case law both prior and subsequent to the adoption of the Code seems to recognize that they are distinct and involve different considerations. *Sztejn* did not address the problem of differentiating between issuer-initiated and court-ordered dishonor, but Justice Shientag, in a subsequent opinion, *Asbury Park & Ocean Grove Bank v. National City Bank,*[103] suggested that factors considered by an issuing bank in deciding whether to honor a credit should not be the same as those that a court would use in deciding whether to enjoin honor of that same credit. *Asbury*

98. *See* notes 114-20 *infra* and accompanying text.

99. U.C.C. § 5-114(2)(b).

100. *Id.* § 5-114, Official Comment 2.

101. *Id.* § 5-114(2)(b).

102. *See* text following note 31 *supra.* By implication, U.C.C. § 5-114(2)(b) also creates a mandatory dishonor situation for the issuer when a draft or demand is accompanied by documents that have defects apparent on their face. The issuer's duty to dishonor in such a case is nothing more than a requirement of good faith on the part of the issuer.

103. 35 N.Y.S.2d 985 (Sup. Ct. 1942), *aff'd mem.,* 268 A.D. 984, 52 N.Y.S.2d 583 (1944).

Park involved a customer who had requested his issuer to dishonor his beneficiary's drafts because he was being defrauded. The issuer, however, continued to honor the beneficiary's drafts despite the pleas of the customer. A suit resulted when the issuer subsequently sold some of the customer's property in order to obtain reimbursement for the payments made under the credit. In holding that the issuer was within its rights in honoring the drafts, the court reasoned that "[t]he common law fraud action is one of the most difficult to prove, and the issuing banks cannot be expected to evaluate the soundness of the . . . claim."[104]

In post-Code cases, courts have continued to show a reluctance to allow issuing banks to evaluate the fraud claims of their customers.[105] The fraud exception to the rule of independent contracts has seen none of the broadening in the elective dishonor cases that it has in injunctive dishonor cases such as *Shaffer* and *NMC Enterprises.*[106] For example, in *Bossier Bank & Trust Co. v. Union Planters National Bank,*[107] an elective dishonor case with facts similar to those in *Shaffer,* the beneficiary was required to present a draft and documents stating that he was "entitled to draw against this letter of credit in reduction of the loan made by the [beneficiary] to [the customer]."[108] The defendant issuer maintained that the beneficiary fraudulently "called" the letter of credit, because the beneficiary sought to have it honored for a purpose not contemplated by the parties to the underlying contract. The underlying contract, argued the issuer, was incorporated by reference into the letter of credit contract through the "entitled to draw" language. The court, however, disagreed:

> As we have . . . concluded that the underlying contract should not be looked to, and that Bossier has complied with the terms of the letter of credit, we must reject defendant's fraud argument. Moreover, the type fraud contemplated in the statute is not the type fraud which the defendant asserts is present here. The Code seems to cover fraud in the factum and not fraudulently calling the letter of credit.[109]

In effect, then, the court strictly applied the narrow view of *Sztejn* and section 5-114 in not allowing the issuer to look to the underlying transaction in order to determine the truth or falsity of the "entitled

104. *Id.* at 989.

105. *Cf.* B. CLARK, *supra* note 46, at 101 (noting that courts seem more willing to review elements of the underlying contract in injunctive dishonor cases than in elective dishonor cases).

106. *See* notes 87-91 *supra* and accompanying text.

107. 550 F.2d 1077 (6th Cir. 1977).

108. *Id.* app. A, at 1081.

109. *Id.* at 1082.

to draw" statement made in the documents. Similarly, in *Pringle-Associated Mortgage Corp. v. Southern National Bank,*[110] another elective dishonor case, the court determined that assertions made in letter of credit documents must be read without reliance on the underlying contract.

> The beneficiary's noncompliance with the underlying contract does not affect the issuer's liability unless a reference to the underlying contract explicitly creates a condition for honoring a draft. General reference to underlying agreements are surplusage and should not be considered in deciding whether the beneficiary has complied with the terms of the letter of credit.[111]

Bossier and *Pringle* are clearly inconsistent with the injunctive dishonor cases, *Shaffer* and *NMC Enterprises,* in which mere "due and owing" language in the letter of credit contracts gave the courts a foothold for looking to the underlying transaction. That the case law should treat elective and injunctive dishonor differently, however, is not surprising. Strong arguments can be made for prohibiting an issuer from basing elective dishonor on its own assessment of fraud in either the underlying transaction or in the documents presented under the letter of credit. Issuers will rarely possess the legal knowledge necessary to assess whether the beneficiary's actions constitute fraud. This deficiency is compounded when the parties involved provide the issuer with self-serving versions of the "facts" of the transaction.[112] In addition, the issuer will often be in no position to make a neutral judgment: it may be predisposed towards the credit in order to protect its reputation in the letter of credit market; alternatively, it may be afraid of alienating an important customer and therefore will look hard to find a reason for dishonoring the credit.[113] In contrast, courts are designed to provide a neutral forum for resolution of both the factual and legal questions involved.

Eliminating the issuer's right of elective dishonor in cases in which the customer alleges fraud would tend to increase commercial utility of letters of credit. It would eliminate the disruption caused when issuing banks wrongfully dishonor either out of allegiance to their customer, out of self-interest, or through mistake.[114] Customers could then secure dishonor only by petitioning a court for an injunction. By limiting the customer's recourse to injunctive dishonor alone, all fraud allegations would be subjected to judicial scrutiny before they are allowed to cause a delay in payment under the credit.

If courts rigorously observe the prerequisites for injunctive relief,

110. 571 F.2d 871 (5th Cir. 1978).
111. *Id.* at 874 (citations omitted).
112. *See* note 104 *supra* and accompanying text; Note, *supra* note 35, at 842-44.
113. *See* Justice, *supra* note 46, at 505-06.
114. *See* notes 42-44 & 103-13 *supra* and accompanying text.

the greater burden imposed on the customer will decrease the number of frivolous or purely dilatory fraud claims. Specifically, the court should first require the plaintiff customer to show that his legal remedy is inadequate:[115] that if payment is made to the beneficiary, the customer will have no effective damage action for breach of the underlying contract.[116] Second, injunctive relief should not be granted except on clear evidence of the validity of the customer's claim on the merits.[117] Even a substantial dispute as to the facts should furnish a strong reason to deny relief.[118] Third, the court should take into account the damage to the beneficiary if it should turn out that relief to the customer was improper. Against this, the court should balance

115. *See* Harfield, *supra* note 46, at 612-14. *See also* Interco, Inc. v. First Nat'l Bank, 560 F.2d 480, 484-86 (1st Cir. 1977); Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172, 181-82 (Minn. 1977); NMC Enterprises, Inc. v. Columbia Broadcasting Sys., Inc., 14 U.C.C. Rep. 1427, 1430 (N.Y. Sup. Ct. 1974). *See generally* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 2.5, at 57-62, 108 (1973).

116. A demonstration of the imminent insolvency of either himself or the beneficiary may satisfy the customer's burden. *See, e.g.*, Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973); Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172, 181-82 (Minn. 1977); NMC Enterprises, Inc. v. Columbia Broadcasting Sys., Inc., 14 U.C.C. Rep. 1427, 1430 (N.Y. Sup. Ct. 1974). *See also* D. DOBBS, *supra* note 115, § 2.5 at 57. It is unclear whether a showing of the hardships of being compelled to carry on international litigation will itself be sufficient. *Compare* Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973) (taking judicial notice of the burden of international litigation while granting an injunction) *with* CAL. U. COM. CODE § 5114, California Code Comment 6 (West 1964) (asserting that the customer accepts the risk of international litigation when he enters into a letter of credit transaction). *See* Harfield, *supra* note 46, at 612-14.

The character of the beneficiary should perhaps be taken into consideration in determining whether an action on the underlying contract will be effectual. If the customer can make a preliminary showing of sufficiently severe beneficiary fraud, that in itself may indicate that no action will be maintainable once the beneficiary is paid:

> If a seller is willing to risk the consequences of a criminal action on fraud, it is quite likely that his assets are either virtually nonexistent or so well hidden that an action in restitution by the distant purchaser would result in nothing but an expensive academic victory for the purchaser.

B. KOZOLCHYK, *supra* note 3, at 282.

117. *See* Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172, 181 (Minn. 1977). *See generally* D. DOBBS, *supra* note 115, § 2.10, at 108-09. In order to make a showing of the validity of the fraud claim sufficient to secure preliminary relief, the customer will have to pass two important substantive thresholds. First, he will have to show that the presenter of the drafts was not a holder in due course. If the presenter was a holder in due course, the customer will be unable to secure dishonor no matter how egregious the fraud. U.C.C. § 5-114(2)(a). If the customer can pass the first threshold by showing that the presenter was not a holder in due course, he must then give sufficient preliminary evidence of the beneficiary's fraud. The standard of fraud to be used should be quite extreme. *See* notes 59-65 *supra* and accompanying text. *See generally* Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172 (Minn. 1977).

118. *See generally* D. DOBBS, *supra* note 115, § 2.10, at 108-09.

the injury that will occur to the customer if relief is wrongly denied.[119]

There are also procedural safeguards available to courts that will further prevent abuse by unscrupulous customers and damage to commercial utility. For example, the customer could be required to give security—by posting a bond, for instance—to further protect the beneficiary in the event a preliminary injunction is improperly issued.[120]

Although it reduces the issuer's flexibility somewhat, elimination of elective dishonor, in the long run, may be in the best interests of the issuing bank. Under section 5-114, an issuer electing to dishonor a draft on grounds of fraud may be liable to the presenter if it is subsequently shown that the presenter was a holder in due course.[121] Under that section, furthermore, if the issuer refuses to honor a draft in reliance on what is later determined to be a baseless claim of fraud, the issuer will again be liable to the presenter.[122] Finally, the issuer's liability for wrongful dishonor is not limited to

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119. *See generally* Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172, 181-82 (Minn. 1977); D. DOBBS, *supra* note 115, § 2.10, at 108-09.

120. *See* Shaffer v. Brooklyn Park Garden Apartments, 250 N.W.2d 172, 182 (Minn. 1977). *See generally* D. DOBBS, *supra* note 115, § 2.10, at 106-07. The Federal Rules of Civil Procedure, as well as most state rules require that the plaintiff provide a bond in cases of preliminary equitable relief. *See* FED. R. CIV. P. 65(c). *See, e.g.*, ILL. ANN. STAT. ch. 69 § 9 (Smith-Hurd 1959 & Supp. 1978); MINN. R. CIV. P. 65.03(1); N.Y. CIV. PRAC. LAW & R. § 6312 (McKinney 1963); PA. R. CIV. P. 1531; TEX. R. CIV. P. ANN. 684 (Vernon 1967). Since most rules requiring bonds give courts discretion to set them in such an amount "as the court deems proper," *see, e.g.*, FED. R. CIV. P. 65(c), courts should take into consideration not only the potential harm to the beneficiary, but also the importance of commercial utility and the need to discourage marginal claims.

121. U.C.C. §§ 5-114(2)(a), 5-115(1). This view is also reflected in a Minnesota group research project:

> Under Subsection (2)(b), which deals with the situation in which the presenter of the draft is not a holder in due course, the issuer may but is not required to honor the draft. This accords with prior law. . . .
>
> Local banking practice, in this situation, is for the issuer to refuse to honor the draft and let the holder and prior interested parties settle their claims and seek recourse against the beneficiary. This practice would probably be changed in view of the provisions in this subsection (2), since under these provisions, the safest practice for the issuer would appear to be to honor the drafts in all cases where there is apparent compliance unless restrained by court order. The issuer is protected by paragraph (b) in so doing, whereas if it elects to dishonor a draft, it is subject to liability to the holder under paragraph (a) if, in a suit against the issuer, the holder proves that he is a holder in due course.

S. KINYON & R. MCCLURE, A STUDY OF THE EFFECT OF THE UNIFORM COMMERCIAL CODE ON MINNESOTA LAW 575 (1964), *reprinted in* MINN. STAT. ANN. § 336.5-114, Minnesota Code Comment, Subsection 5-114(2) (West 1976).

122. *See* Justice, *supra* note 46, at 497; Mentschicoff, *How to Handle Letters of Credit*, 19 BUS. LAW. 107, 111 (1963).

the amount of the dishonored draft. Incidental damages may also be awarded a beneficiary whose demand for payment has been wrongfully dishonored.[123]

Under the present section 5-114, a bank may be pressured into elective dishonor by an influential customer,[124] thus exposing itself to liability in an eventual wrongful dishonor suit. If only injunctive dishonor is allowed, the bank will be able to follow the more certain course of honoring drafts in all cases unless it is presented with a court order. If the bank perceives a serious danger of not being reimbursed by a client alleging fraud, it should be allowed to seek an injunction itself.[125]

Banks should retain the power of elective dishonor only when the documents or drafts presented by a beneficiary are forged. In such cases, the issuer is in a much better position to determine the validity of a customer's claims. Banks are accustomed to dealing with problems of forgery, unlike other problems of fraud. In cases of forgery the bank may limit its scrutiny to the face of the documents presented.

IV. A SUGGESTED REVISION OF SECTION 5-114

Solving the problem of fraud and the letter of credit requires that the poorly drafted section 5-114 be revised. First, the term "fraud" should be defined in the section and its accompanying official comment. Although a precise definition may be impossible, the statute should at least indicate that the beneficiary's malfeasance must be intentional and that the defectiveness of his performance must be extreme. Second, the very different elective and injunctive dishonor situations should be treated separately. Issuers should never be permitted to look beyond the documents presented. Their scrutiny of those documents should be strictly limited to examination for facial conformity to the requirements of the letter of credit contract[126] and detection of forgery. In entertaining petitions for injunction based on allegations of customer fraud, however, courts should not be limited by the words of the documents presented to the issuing bank. In order to prevent unjust enrichment, they should be able to examine the beneficiary's performance of the underlying transaction directly. In

123. U.C.C. § 5-115(1). *See also* Justice, *supra* note 46, at 497.

124. *See* Justice, *supra* note 46, at 505.

125. *Cf.* B. KOZOLCHYK, *supra* note 3, at 281 n.1 (discussing injunction ordering the beneficiary not to draw under the credit).

126. Issuers should also be able to examine the documents to determine whether they conform to "the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a security (Section 8-306)," as U.C.C. § 5-114(2) already provides. This right to reject documents not in conformity with warranties is necessary for the issuer to protect its security interest in property being transferred in the underlying transaction. *See* note 41 *supra*.

order to preserve the commercial utility of letters of credit, though, the section and comment should reaffirm that the full panoply of equitable prerequisites will prevent specious fraud claims from causing delay in payment.

The following is a proposed revision of Section 5-114, accompanied by a proposed comment.[127]

> (1) [Subsection (1) is unchanged.][128]
>
> (2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document *is forged or* does not in fact conform to the warranties made on negotiation or transfer of a document of title ~~(Section 7-507) or of a security (Section 8-306) 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 negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a security (Section 8-302); 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 *nonconformity to warranties* ~~other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.~~
>
> (3) *When documents on their face comply with the terms of a credit but a required document is forged or does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a security (Section 8-306), or when under all the circumstances payment would constitute a fraud upon the issuer or customer, and when honor is demanded by one other than a negotiating bank or other holder of the draft or demand that has taken the draft or demand under the credit and under circumstances that would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a security (Section 8-302) a court*

127. Additions to the current section are *italicized*; deletions are indicated by ~~strike-over~~.

128. *See* text accompanying note 29 *supra*.

of appropriate jurisdiction, upon application of the issuer or customer, may enjoin honor of the credit.[129]

Proposed Comment:

[Subsection (1) is unchanged.]

Subsection (2) allows an issuing bank a limited right to dishonor a credit even though the documents appear on their face to comply with the credit. The right accrues only when a required document is forged or does not conform to the warranties arising under other Articles of the Code.

Subsection (3) allows a court of appropriate jurisdiction to examine the underlying transaction when the customer or the issuing bank raises a claim of fraud. But, in light of the basic rule of the independence of the issuer's engagement and the importance of this rule to the effectuation of the purposes of the letter of credit, the circumstances that will justify an injunction against honor are intended to be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the issuer's obligation would no longer be served. Hence, the subsection contemplates a strict standard of fraud that includes an element of intentional misrepresentation on the part of the beneficiary. In addition, courts granting injunctions under this section should strictly adhere to the traditional prerequisites for equitable relief. The moving party should be required to show that his legal remedy is inadequate, that he is likely to prevail on the merits, and that damage to the beneficiary if relief is improperly granted would be less than damage to the moving party if relief is improperly denied. Furthermore, the customer should be required to provide security, in the form of a bond, in an amount that the court deems adequate to protect the beneficiary.

V. CONCLUSION

Essentially, the suggested revised statute and accompanying comment make three important changes in the existing statute. First, in subsection (2), dealing with injunctive dishonor, the revision eliminates the issuer's "privilege" to dishonor when documents are "fraudulent" or there is "fraud in the transaction." By eliminating the issuer's elective dishonor for fraud, the revision would reduce wrongful dishonor litigation and would increase the utility of letters of credit by making the issuer's promise to pay more certain. It would also make more acute the need for the issuer's careful assessment of

129. Subsection (3) is entirely new. Existing subsection (3) would become subsection (4) in the revised version of § 5-114; existing optional subsections (4) and (5) would become subsections (5) and (6) respectively.

the risk prior to commitment in a letter of credit arrangement, especially in the standby context where issuers have been eager to exercise elective dishonors in the past.[130] Second, in subsection (3), concerning injunctive dishonor, the revision explicitly empowers the court to consider "all the circumstances" including (and especially) the underlying contract. This affords the customer and the issuer full protection from fraud regardless of the form of credit. Finally, the comment makes it clear that an injunction against honor may issue only when the customer or issuer can show a very serious misrepresentation by the beneficiary and can satisfy the prerequisites for equitable relief. The revised statute thus gives some certainty to a confused area of commercial law, providing relief from fraud to the customer or issuer while preserving the commercial utility of letters of credit.

130. *See* notes 40-45 *supra* and accompanying text.