1980

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UCC Sections 5-102 and 5-103: A Solution to the Stand-by Letter of Credit Identity Crisis

INTRODUCTION

In the past decade, United States banks have increasingly welcomed and encouraged a new market for their credit services—the stand-by letter of credit.¹ Five billion dollars in stand-by letters of credit issued by United States banks and their foreign branches were outstanding in December, 1973.² By December, 1978, the figure had jumped to twenty-five billion dollars.³ Stand-by letters of credit have enabled the banking industry to expand its role in the business community.⁴ For instance, banks can now profitably compete with the surety industry in assuring performance of both domestic and international construction projects.⁵

1. The letter of credit has been a favorite credit device for centuries. It has been suggested that the letter of credit was used in ancient times by the Phoenicians, the Babylonians, the Assyrians and the Greeks. Wiley, How to Use Letters of Credit in Financing the Sale of Goods, 20 BUS. LAW. 495 (1965) [hereinafter cited as Wiley]. Others cite 575 B.C. as the birth date of the letter of credit. W. WARD and H. HARFIELD, BANK CREDITS AND ACCEPTANCES (4th ed. 1958) [hereinafter cited as WARD & HARFIELD]. Its traditional role has been to finance the sale of goods between distant merchants unfamiliar with each other's reliability and creditworthiness. Wiley, supra, at 496. The stand-by letter of credit is a more recent development. See Note, Recent Extensions in the Use of Commercial Letters of Credit, 66 YALE L. REV. 902 (1957). It has greatly increased the domestic use of the letter of credit. See Harfield, The Increasing Domestic Use of the Letter of Credit, 4 U.C.C.L.J. 251 (1972).


3. Id.

4. See Murray, Letters of Credit in Non-Sale of Goods Transactions, 30 BUS. LAW. 1103, 1104-05 (1975) [hereinafter cited as Murray] for a representative list of transactions in which the stand-by letter of credit has been used.

5. See Note, Guaranty Letters of Credit: Problems and Possibilities, 16 Ariz. L. Rev. 822, 826 (1974). The bank competes by charging the customer a much lower fee. Banks generally issue stand-by letters of credit at a fee of ½% to 1% per annum of the face amount of the credit. Surety companies charge a flat sliding-scale fee based on the size of the construction contract involved, not the risk. For example, if a one-year construction contract is worth $50,000,000, and the owner requires a $5,000,000 performance bond from the contractor, the contractor's fee to the surety company for a bond would be $252,000; the fee for a stand-by letter of credit would be closer to $25,000. Garman, Standby Letters of Credit and Guarantees: Do We Understand What We're Doing, 1978 J. COM. BANK LENDING 3, 8 [hereinafter cited as Garman]. The surety bond costs more simply because the surety does more. Besides assuring itself that the contractor is financially able to complete the contract, the surety company takes measures to prevent the contractor's default. See text accompanying note 26 infra.

On the other hand, the bank which issues the stand-by letter of credit must never involve
Furthermore, during tight money market periods, stand-by letters of credit permit a bank to lend its credit instead of cash, at only a fraction of the prime lending rate. The low cost and flexibility of letters of credit and the engagement of a strong and reputable financial institution in a transaction have attracted the business community to stand-by letters of credit issued by banks.

However, the use of stand-by letters has created some legal problems. Because the stand-by letter of credit promises payment only upon the customer's default and has often been used in place of the conventional guaranty, it has been characterized as a guaranty. Consequently, its issuance by banks has been challenged as ultra vires. Since the bank's obligation to pay under the stand-by itself in the performance of the contractor's contract. See notes 32 and 36 infra and accompanying text. The bank will rely solely on the presentment of documents informing it of the contractor's default and its obligation to pay the owner. If the documents are in proper order, the bank must pay. Thus, the bank's operational costs are much lower. The bank needs no extensive technical knowledge about the construction industry; it need only do what it does best — evaluate the creditworthiness of the contractor and his ability to repay the bank if the owner draws on the letter of credit. See Ward & Harfield, supra note 1, at 135, 138. In fact, in his most recent edition, Harfield notes that sureties themselves are giving greater priority to the financial standing of their customers. H. Harfield, Bank Credits and Acceptances (5th ed. 1974) [hereinafter cited as Harfield].


7. For the purpose of applying legal lending limits, the Comptroller of the Currency defines the stand-by letter of credit as "an obligation to the beneficiary on the part of the issuer . . . to make payment on account of any default by the account party in the performance of an obligation." 12 C.F.R. § 7.1160(a) (1980). The Comptroller uses "account party" to mean the bank's customer. See text accompanying notes 44 to 48 infra.

8. Murray, supra note 4, at 1103.


10. Katskee, supra note 9, at 704. In America, it has been generally held that a bank has no power to guarantee the contracts of others in which it has no interest and from which it derives no benefit. Border Nat'l Bank v. American Nat'l Bank, 282 F. 73 (5th Cir. 1922); Commercial Nat'l Bank v. Pirie, 82 F. 799 (8th Cir. 1897); J. Morse, 1 Bank and Banking § 65 (6th ed. 1928) [hereinafter cited as Morse]; C. Zollmann, 8 Bank and Banking § 5101 (1936). This prohibition applies especially to national banks. Bowen v. Needles Nat'l Bank, 94 F. 925 (9th Cir. 1899); Commercial Nat'l Bank v. Pirie, 82 F. 799 (8th Cir. 1897). National banks are said to have only such powers as they are expressly given by statute. Colorado Nat'l Bank v. Bedford, 310 U.S. 41, 48-50 (1940). The courts have distinguished bank guaranties of endorsement on checks handled for collection or re-discounted notes on the theory that the bank is simply disposing of property it has lawfully acquired. Such practices are deemed incidental to the business of banking and permitted by statutes. Cochran & Sayre v. United States, 157 U.S. 286 (1895); People's Bank v. National Bank, 101 U.S. 1811 (1879); Merchants' Bank v. Baird, 160 F. 642 (8th Cir. 1908). The Comptroller of the Currency also permits a national bank "to become a guarantor, if it has a substantial interest in the performance of the transaction . . . or has a segregated deposit sufficient . . . to cover the
Stand-by Letter of Credit

The letter of credit becomes void if the letter is held to be a guaranty,\textsuperscript{11} banks seeking to avoid their payment obligations have raised the "no guaranty" defense.\textsuperscript{12}

This challenge continues to jeopardize the utility of the stand-by letter of credit, whose hallmark is the beneficiary's justified reliance on the bank's absolute promise to pay upon presentation of proper documents. Although the stand-by letter of credit has been sanctioned by the Comptroller of the Currency,\textsuperscript{13} state regulatory

bank's total potential liability," 12 C.F.R. § 7.7010(a) (1980). The assumption has been that lending credit creates too great a risk for the bank, which acts as a fiduciary for its depositors. Lord, The No-Guaranty Rule and the Standby Letter of Credit Controversy, 96 Banking L.J. 46 (1979). One commentator summed it up: "Indeed, lending credit is the exact opposite of lending money, which is the real business of a bank." Morse, supra, at 184. However, the courts have continually upheld a bank's power to issue letters of credit. See, e.g., Second Nat'l Bank v. Columbia Trust Co., 288 F. 17 (3d Cir. 1923); Border Nat'l Bank v. American Nat'l Bank, 282 F. 73 (5th Cir. 1922); Lamborn v. National Park Bank, 212 App. Div. 25, 208 N.Y.S. 428 (1925). See also Ward & Harfield, supra note 1, at 135.


12. Generally, banks refuse payment under their stand-by letters of credit for one of two reasons. A bank may not understand the stand-by letter of credit and, thus, may make an improper credit decision. See Harfield, Code, Customs and Conscience in Letter-of-Credit Law, 4 U.C.C.L.J. 7, 14 (1972). Because no party to the credit anticipates drawing under the credit, a bank officer may agree to issue a stand-by letter of credit for a customer whose financial condition would not justify granting a loan of money, see Harfield, The Increasing Domestic Use of the Letter of Credit, 4 U.C.C.L.J. 251, 258 (1972), or the bank may fail to prudently secure itself against an unexpected demand for payment under the letter. When the demand is then made, the bank refuses payment in a belated effort to protect itself. The Federal Reserve Board has attempted to discourage this practice. In regulating state member banks, the Board requires that the issuance of stand-by letters of credit be subject to the same credit analysis as potential loans. 12 C.F.R. § 208.8(d)(2)(ii) (1980).

Alternatively, a dispute may arise between the customer and the beneficiary. The customer may then pressure the bank to dishonor the beneficiary's demand for payment. If the bank values its relationship with the customer, it may accept the customer's indemnification and refuse payment. In Talbot v. Bank of Hendersonville, 495 S.W.2d 548 (Tenn. Ct. App. 1972), the customer convinced the bank to withhold payment for about 45 days after demand for payment was made. The bank finally paid the beneficiary over the customer's objections.

13. See 12 C.F.R. § 7.1160 (1980). Although the regulation does not expressly permit stand-by letters of credit, it subjects the stand-by letter of credit to the federal legal lending limit requirements of 12 U.S.C. § 84 (1976), implying that national banks may issue stand-by letters of credit. Similar provisions can be found in the Federal Deposit Insurance Corporation's regulations on state non-member banks, 12 C.F.R. § 337.2(b) (1980), and the Federal Reserve's regulations of state member banks, 12 C.F.R. § 208.8(d)(2)(i) (1980).

A recent commentator suggests that a 1977 amendment to the Comptroller's regulations sanctions stand-by letters of credit by what it does not say. Although 12 C.F.R. § 7.7016 (1980) describes sound banking practices for letters of credit, it also authorizes national banks to issue any letter of credit permissible under the Uniform Commercial Code or the
authority and case law, the guaranty prohibition lives on. A clear and effective test for courts and practitioners to distinguish the valid stand-by letter of credit from the ultra vires guaranty is necessary to discourage banks from proliferating the stand-by letter of credit when it suits them, but undermining its efficacy when it does not. Many courts have recently struggled with the stand-by letter of credit/guaranty question and have discovered a valuable test in Article 5 of the Uniform Commercial Code: sections 5-102 and 5-103.

The standard form of the letter of credit prescribed by sections 5-102 and 5-103, as interpreted by the courts, should assist banks’ counsel in drafting an instrument that avoids an ultra vires challenge. The courts’ implementation of sections 5-102 and 5-103 to spurn the guaranty defense should dissuade banks from improperly refusing payment under the stand-by letter of credit. Beneficiaries applying this test should recognize when a bank’s instrument is susceptible to a subsequent guaranty attack. This may avoid possible litigation and excessive losses due to misplaced reliance.

The purpose of this article is to describe the tests under sections 5-102 and 5-103 which assist in distinguishing the stand-by letter of credit from the guaranty and to review recent court implementation of these tests when faced with a guaranty challenge. After a discussion of the differences among the stand-by letter of credit, its traditional counterpart and the common law guaranty, Code sections 5-102 and 5-103 will be examined. Finally, the courts’ interpretations, applications, and misapplications of these two sections, as well as the courts’ general rejection of the guaranty defense, will be explored.

THE LETTER OF CREDIT/GUARANTY DISTINCTION

To appreciate the utility of sections 5-102 and 5-103, it is necessary to understand the way in which the recently developed stand-by letter of credit differs from both the guaranty and the traditional letter of credit. The letter of credit and the guaranty both

15. See text accompanying notes 71-106 infra.
fulfill the "assurance" function. Both instruments assure a third party of the bargained-for performance (often payment) of an underlyng contract with the issuer's customer. However, although the letter of credit and guaranty have the same general function, they operate differently. Because of this difference, and because of their diverse historical beginnings, two distinct sets of legal principles have developed around their use.

The Guaranty

The surety who issues the guaranty is concerned with actual performance. He undertakes to provide the performance promised by his principal to a third party should the principal default. For instance, in a construction project, the surety's activities might

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16. "Indeed, the essential distinction between the letter of credit and the contract of guaranty is purely formal, not functional." Bank of North Carolina v. Rock Island Bank, 570 F.2d 202, 206 n.7 (7th Cir. 1978).

Harfield has noted, "A letter of credit always serves as a guaranty." Harfield, Code Treatment of Letters of Credit, 48 CORNELL L.Q. 92, 93 (1962). Early use of the letter of credit in America illustrated this similarity of function. Professor K. N. Llewellyn described it thus: "In the first decades, in domestic commerce, the letter of credit appears chiefly in the form of a guaranty addressed by one merchant to another," reprinted in Harfield, supra note 5, at 165. Both the instrument and the courts often used the terms letter of credit and guaranty interchangeably. See, e.g., Decatur Bank v. St. Louis Bank, 88 U.S. (21 Wall.) 294 (1874); Omaha Nat'l Bank v. First Nat'l Bank, 59 Ill. 428 (1871). Indeed, it is ironic that after strongly admonishing banks against issuing guaranties, Morse distinguished a letter of credit from a guaranty with this definition: "A letter of credit is a guaranty to be responsible for the debt of another." Morse, supra note 3, at 185 (emphasis added).

17. See note 1 supra. By the 17th century, the letter of credit was a highly developed tool of international trade for European merchants. Kozolchyk, The Legal Nature of the Irrevocable Commercial Letter of Credit, 14 AM. J. COMP. L. 395 (1965). The governing legal principles were thus shaped by civil law doctrines and the law merchant. Hershey, Letters of Credit, 32 HARV. L. REV. 1 (1918). On the other hand, the guaranty has a long tradition in the common law. See Loyd, The Surety, 66 U. PA. L. REV. 40 (1917); Morgan, The History and Economics of Suretyship, 12 CORNELL L.Q. 153 (1927).

18. "Surety" is used herein in its broad sense as synonymous with guarantor. L. Simpson, Handbook on the Law of Suretyship 6 (1950) [hereinafter cited as Simpson]. It refers to the surety who is secondarily liable, in contrast to the surety who has a primary obligation. Id. at 8 n.10. This is consistent with the use of the term by courts and commentators. See, e.g., Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 114 (Tex. 1978); American Empire Ins. Co. v. Hanover Nat'l Bank, 409 F. Supp. 459, 464 (M.D. Pa. 1976). See also Ward & Harfield, supra note 1, at 133.


20. Instead of promising to complete performance, the surety may just promise to pay agreed-upon damages for the principal's failure to perform. Ward & Harfield, supra note 1, at 132.

21. Id. See also Simpson, supra note 18, at 10. The guaranty has often been defined as a promise to answer for some debt of another. See, e.g., Border Nat'l Bank v. American Nat'l Bank, 282 F. 73, 77 (5th Cir. 1922).
include monitoring the contractor's progress, redressing the owner's complaints concerning job quality, assisting a financially stricken contractor, or even hiring a new contractor to complete the job.\textsuperscript{22} Thus, the surety's interest lies in the fulfillment of the contract. His obligation to the third party, however, always remains secondary.\textsuperscript{23} The third party may look to the surety only after the principal has, in fact, defaulted.\textsuperscript{24}

For his part, the principal promises to reimburse the surety only if he actually defaults.\textsuperscript{25} Before the surety advances funds, therefore, it is prudent that he inquire into the actual fact of the principal's default.\textsuperscript{26} He must determine whether there has been a default to be certain of his recovery from the principal. In addition, since the guarantor's obligation is dependent upon the principal's obligation, any defenses which relieve the principal of his obligation to the third party may be raised by the surety as well.\textsuperscript{27} The secondary nature of the surety's obligation, which depends on the actual facts of the customer's performance, makes the guaranty quite a different instrument from the letter of credit.

The Letter of Credit

The issuer of a letter of credit is not concerned with the actual performance of the contract between the customer and the third party (the beneficiary). Rather, the issuer's only interest is documents.\textsuperscript{28} The issuer of a letter of credit promises to pay the beneficiary upon receipt of documents specified in the letter. Section 5-103 of the Uniform Commercial Code defines a letter of credit as

\begin{itemize}
  \item 22. Garman, supra note 5, at 7-8.
  \item 23. Simpson, supra note 18, at 10.
  \item 24. The third party must look first to the principal for performance. Only when the principal has unjustifiably failed to perform may the third party turn to the surety. See American Empire Ins. Co. v. Hanover Nat'l Bank, 409 F. Supp. 459, 464 (M.D. Pa. 1976). If, however, the principal's failure to perform is justified, the surety's obligation, secondary to the principal's, is also discharged. See Simpson, supra note 18, at 265-295.
  \item 25. Simpson, supra note 18, at 226. However, if the principal has valid defenses for non-performance or against the third party, and the surety knows of these defenses, the principal may raise them against the surety as well. Simpson, supra note 18, at 229. Thus, a contractor may refuse to reimburse the surety for the completion of a construction project if the contractor had good defenses for non-completion. See Ward & Harfield, supra note 1, at 134.
  \item 26. Ward & Harfield, supra note 1, at 133-134.
  \item 27. Simpson, supra note 18, at 265-295.
\end{itemize}
"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. . . ." The actual performance of the customer's contract is irrelevant to the issuer's obligation to pay. In fact, courts have often said the issuer must not even inquire into the actual facts of the underlying contract. The Code expresses this important principle in section 5-114(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. . . ." The issuer focuses solely on documentary compliance with the conditions set forth in the letter.

Like the surety's principal, the customer promises to reimburse the issuer for proper payment. Proper payment is predicated upon presentation of complying documents, however, not upon the customer's actual performance. Both the issuer's promise to pay the beneficiary and the customer's promise to reimburse the issuer are conditioned upon proper documentation. These obligations are separate and independent of the underlying contract between the customer and the beneficiary. Therefore, unlike the guarantor,
the issuer who refuses to pay cannot assert the customer's defenses arising from the factual circumstances of the underlying contract; nor can the customer employ these defenses to avoid reimbursement. In contrast to the secondary obligation of the guaranty, the letter of credit creates a primary obligation of the issuer to the beneficiary. These principles apply whether the credit is of the traditional merchandise variety or is a stand-by letter of credit.

The Traditional Letter of Credit

The traditional letter of credit is employed in the sale of goods. The seller receives the bank's promise to pay the purchase price of the merchandise as specified in the letter. The seller must present documents which evidence proper shipment of the purchased goods, usually bills of lading, invoices, certificates of insurance or the like. The buyer and seller, in effect, agree that the seller will no longer look to the buyer for payment. He will, instead, rely primarily on the bank to pay him. The bank expects that, if all goes well, it will be called upon to pay the seller. Thus, in the tradi-

36. See text accompanying note 27 supra.
38. See Note, Recent Extensions in the Use of Commercial Letters of Credit, 66 YALE L. REV. 902, 904 n.8 (1957); WARD & HARFIELD, supra note 1, at 78, 80.
40. See note 1 supra.
41. See S. MENTSCHIKOFF, COMMERCIAL TRANSACTIONS: CASES AND MATERIALS 212 (1970) for an excellent description of a typical merchandise letter of credit transaction.
42. Prior to issuing the credit, the bank can take a security interest in the negotiable documents of title, the merchandise and the proceeds from the sale of the goods. Kozolchyk, Legal Aspects of Letters of Credit and Related Secured Transactions, 11 LAW. OF THE AMERICAS 265, 273 (1979) [hereinafter cited as Kozolchyk]. Such security interest is temporarily perfected without filing for 21 days after execution of the security agreement. U.C.C. § 9-304(4) (1978 version). The bank may also require that it be shown as titleholder of the goods in the documents of title as security for prompt reimbursement by the buyer-customer. If the documents of title are in the name of the customer, the bank can create a security interest in them by releasing them to the customer under a trust receipt. Kozolchyk, supra, at 273. This security interest is also temporarily perfected for 21 days without filing a financing statement. U.C.C. § 9-304(5) (1978 version).
43. Since the stand-by letter of credit transaction usually does not involve a sale of goods, some argue that it is a much more risky affair. See, e.g., Verkuil, Bank Solvency and Guaranty Letters of Credit, 25 STAN. L. REV. 716, 723 (1973). However, the issuer of a stand-by letter of credit can protect itself by requiring the customer to deposit a segregated fund to cover the amount of the credit. Kozolchyk, supra, at 273. The bank should view the credit as any other loan and take collateral, if necessary. Recent empirical evidence of the rela-
tional merchandise letter of credit, the bank’s obligation is primary, not secondary, to the customer’s obligation to perform.

The Stand-by Letter of Credit

The primary obligation of the issuer to the beneficiary is not so readily apparent in a stand-by letter of credit.\(^4\) The bank issuing such a letter in effect promises to pay the beneficiary if the customer defaults in performance of the underlying contract.\(^4\) For example, when a bank’s customer borrows money from another bank, the first bank might issue a letter of credit as collateral for the loan, promising to pay the note if the customer does not.\(^4\) A bank may issue a letter of credit to an insurance company promising to pay liquidated damages if the customer fails to take a mortgage loan offered by the insurance company.\(^4\) In either example, all parties to the transaction expect the customer to complete his promised performance. The beneficiary looks to the customer to pay the loan or take the mortgage. The bank only “stands by” in case the customer defaults. No one expects a draw on the bank’s letter of credit.\(^4\) Whereas the traditional letter of credit will be drawn upon “if all goes well,” the stand-by letter of credit will only be drawn upon if all does not.\(^4\) In this sense, it operates exactly like a guaranty.

Nevertheless, the distinction between a stand-by letter and a guaranty lies in the documentary nature of the letter of credit. The bank issuer will pay the beneficiary not when the customer in fact defaults, but when it receives documents which notify it of that default.\(^4\) In the examples above, the bank would pay upon receipt

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9. An obvious risk for the customer is that the beneficiary will fraudulently notify the issuer of a non-existent default. The leading pre-Code case dealing with the problem of
of its customer's past due promissory note or on the insurance company's written declaration that the bank's customer failed to take the mortgage. Thus, the bank's obligation is not dependent upon the actual facts of the underlying contract; it is an independent and primary obligation to pay the beneficiary upon receipt of proper documents.

Therefore, although the surety and the issuer of a letter of credit both perform the "assurance" function, they operate quite differently. The surety performs the "assurance" function by inquiring into the nature of the underlying contract and making certain that his principal has, in fact, failed to perform a proper obligation. In contrast, the issuer of a letter of credit performs the "assurance" function in a sale of goods credit is Sztejn v. J. Henry Schroeder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). The beneficiary in that case had contracted to sell the bank's customer certain bristles. Although the documents received by the bank described the proper bristles required under the letter of credit, the customer claimed that the material shipped was, in fact, "cowhair, other worthless material and rubbish." 31 N.Y.S.2d at 633. The customer brought an action to restrain the bank from paying the beneficiary against fraudulent documents. The court found that the general rule of independence of contracts in a letter of credit transaction was applicable to cases of breach of warranty in the underlying contract, but that this principle "should not be extended to protect the unscrupulous seller." Id. at 634. The court denied defendant's motion to dismiss for failure to state a cause of action.

The rule of Sztejn is codified in U.C.C. § 5-114(2). It permits a bank acting in good faith to decide on its own whether or not to pay the beneficiary upon documents which comply on their face, despite the claim that the documents are forged or fraudulent, or that "there is fraud in the transaction." However, in keeping with Sztejn, the customer may seek to enjoin such payment. This remedy is not available against a holder in due course of defective documents or the bona fide purchaser of securities. U.C.C. § 5-114(2)(a).

Questions remain. What kind of fraud is necessary to permit dishonor? Does "fraud in the transaction" include the underlying contract or only the face of the documents? Should the bank have the discretion to dishonor documents which comply on their face? These questions are discussed and solutions suggested in Note, Letters of Credit: Injunction as a Remedy for Fraud in U.C.C. Section 5-114, 63 MINN. L. REV. 487 (1978). See also Siderius, Inc. v. Wallace Co., 583 S.W.2d 852 (Tex Ct. App. 1979); O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 250 S.E.2d 587 (1978).

Due to the recent political turmoil in Iran, several U.S. concerns sought injunctions against honor of stand-by letters of credit issued in favor of Iranian banks. Each customer alleged fraud under U.C.C. § 5-114(2). In each case, the appellate court refused to enjoin payment under the letter of credit because the parties failed to prove fraud. KMW Int'l v. Chase Manhattan Bank, 606 F.2d 10 (2d Cir. 1979); United Technologies Corp. v. Citibank, 469 F. Supp. 473 (S.D.N.Y. 1979); American Bell Int'l v. Islamic Republic of Iran, 27 U.C.C. REP. SERV. 223 (S.D.N.Y. Aug. 4, 1979).

function by receiving the documents that inform him of either the beneficiary’s performance or the customer’s lack of performance of their obligations in the underlying contract. This difference in method makes the surety’s obligation secondary, and allows him to stand in the shoes of the principal in case of nonpayment. The issuer’s obligation, on the other hand, is always primary, and he may raise none of the customer’s defenses for non-payment.

**The Test Provided by Sections 5-102 and 5-103: Scope and Definition**

Since a bank’s instrument will be void as *ultra vires* if it is held to be a guaranty, a court must determine whether the instrument in question is an invalid guaranty or a valid stand-by letter of credit. Merely to describe the issuer’s obligation under a letter of credit as “primary” is inadequate, particularly with the stand-by letter of credit, in which the issuer’s obligation appears to be secondary to the customer’s duty to perform. The documentary requirement gives rise to the issuer’s primary obligation to the beneficiary and distinguishes a stand-by letter of credit from a guaranty. Yet, since the assurance function is common to both instruments, form becomes decisive. The first step must be to de-

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53. See note 10 supra.

54. See Bank of N. Carolina v. Rock Island Bank, 570 F.2d 202, 206 n.7 (7th Cir. 1978). Early cases held that the letter of credit need take no particular form. Violett v. Patton, 9 U.S. (5 Cranch) 142 (1809); Border Nat’l Bank v. American Nat’l Bank, 282 F. 73 (5th Cir. 1922). However, more recent commentators have recognized that the form of the instrument is material in determining its usefulness as a letter of credit. Kozolchyk thoroughly studied the use of the modern letter of credit and determined that “[a]s a formal promise, the letter of credit may no longer be treated as an instrument whose form is immaterial and whose requisites are to be determined by random considerations.” Kozolchyk, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 AM. J. COMP. L. 395, 421 (1965). Speaking of the recent burgeoning of stand-by letters of credit, Armstrong found that “it is apparent at this point that in the world of documentary credits form is everything. That is so because without its special attributes of form, the [stand-by] arrangement described takes on the cast—or pallor—of acceptances, guaranties, and suretyship agreements. . . .” Armstrong, *The Letter of Credit as a Lending Device in a Tight Money Market*, 22 BUS. LAW. 1105, 1107 (1967). See also Harfield, supra note 5, at 176.

The modern merchandise letter of credit is not normally confused with the guaranty, because it has developed a highly specialized form through extensive use in international trade. This form has been solidified in the Uniform Customs and Practice for Commercial Documentary Credits (UCP) of the International Chamber of Commerce, which has been widely adopted by the commercial community since its introduction in 1929. The UCP is a compilation of existing business practice and law pertaining to the commercial merchandise letter of credit. See Wheble, *Uniform Customs and Practice for Documentary Credits 1971 Revision*, 4 CORNELL INT’L L.J. 97 (1971); Note, *Revised International Rules for Documentary Credits*, 65 HARV. L. REV. 1420 (1952).
termine whether the instrument fits within the documentary format of the stand-by letter of credit.

Sections 5-102 and 5-103 provide the courts with the standard form by which to measure the instrument in question. The drafters of Article 5 recognized that form is determinative in distinguishing the letter of credit from other, similar instruments. They established three form tests in sections 5-102(1)(a), (b) and (c) and incorporated them into the definition of “letter of credit” found in section 5-103(1)(a).

Section 5-102 describes the scope of Article 5, Letters of Credit. Its purpose is to delineate the transactions to which letter of credit legal principles will apply. Article 5 applies to letters of credit regardless of the nature of the underlying transaction. It does not differentiate in any way between the merchandise and the stand-by letter of credit. Sections 5-102(1)(a) and (b) illustrate the primary distinction between the letter of credit and the guaranty, i.e., reliance on documents.

Section 5-102(1)(a) provides that a credit issued by a bank falls within the scope of Article 5 when that credit requires for payment a documentary draft or documentary demand for payment. Under section 5-102(1)(b), a credit issued by a person other than a bank is within Article 5 if the credit calls for a document of title to accompany the draft or demand for payment.

In contrast, the stand-by letter of credit has been utilized in such a great variety of situations that it is difficult to recognize any particular attributes. See note 4 supra. This further confounds the courts faced with the task of distinguishing the almost indistinguishable stand-by letter of credit from the ordinary guaranty.

55. Section 5-104 sets out the “formal requirements” of the letter of credit. It codifies the early common law rule that a letter of credit need follow no particular form. See note 54 supra. No special phrasing is necessary, except as may be required by § 5-102(1)(c). The credit must be in writing and it must be signed. U.C.C. § 5-104(1)(a) (1978 version). The term “form test” is used in this article in response to contemporary commentators and courts who have emphasized that the stand-by letter of credit is identical to the guaranty in its “assurance” function and that the real distinction lies in form. See note 58 infra and accompanying text.


58. “(1) This Article applies (a) to a credit issued by a bank if the credit requires a documentary draft or a documentary demand for payment. . . .” U.C.C. § 5-102(1)(a) (1978 version).

59. “(1) This Article applies. . .(b) to a credit issued by a person other than a bank if the credit requires that the draft or demand for payment be accompanied by a document of title. . . .” U.C.C. § 5-102(1)(b) (1978 version).

60. Whereas a bank issuing a letter of credit may require that any document, as defined in § 5-103(1)(b), accompany the draft or demand for payment, a letter of credit issued by
Section 5-102(1)(c)61 provides the exception to the documentary nature of the stand-by letter of credit. If the instrument does not comply with either section 5-102(1)(a) or (b), and yet states conspicuously that it is a “letter of credit,” it may be construed as one under Article 5.62 This section gives effect to the express intention of the parties to utilize a letter of credit and benefit from the letter of credit legal principles, without requiring documents for payment.63

Section 5-102(2)64 illustrates the drafters’ recognition of the similarities between the letter of credit, the guaranty and other instruments. It expresses the rule that the form of the instrument, as described in section 5-102(1), distinguishes those instruments which will be construed as letters of credit from those which fall outside the scope of Article 5.65

any other person must require a document of title. However, the practical effect of these strict rules is weakened by the §5-102(1)(c) exception. See notes 94 to 106 infra and accompanying text.

61. “(1) This Article applies. . . (c) to a credit issued by a bank or other person if the credit is not within subparagraphs (a) or (b) but conspicuously states that it is a letter of credit or is conspicuously so entitled.” U.C.C. § 5-102(1)(c) (1978 version).

62. Comment 1 to § 5-102 suggests that § 5-102(1)(c) authorizes a “clean” credit — one that requires no documents. However, § 5-102(1)(c) credits still require “a draft or other demand for payment” pursuant to the definition of letter of credit in § 5-103(1)(a). Compared to §§ 5-102(1)(a) and (b), which the Comment refers to as “mandatory” sections, this section is considered “permissive.” Although these labels are left unexplained by the Comment, it appears that the letters which take the specified form of § 5-102(1)(a) or (b) will be held to be letters of credit regardless of the intention of the parties, whereas a letter which falls under § 5-102(1)(c) will be permitted to stand as a letter of credit when the parties’ intention to enter into a letter of credit agreement is clear. The Comment further indicates that both banks and other parties may issue “clean” credits. For an example of a “clean” credit transaction, see Baker v. National Boulevard Bank, 399 F. Supp. 1021 (N.D. Ill. 1975). See also note 113 infra and accompanying text.

63. However, precisely because this section eschews the documentary requirement, its application to the stand-by letter of credit is problematic. If the distinction between the stand-by credit and the guaranty lies in the documentary format of the letter of credit, when the documentary requirement is eliminated, a crucial feature is lost. See text accompanying notes 107 to 122 infra.

64. “(2) Unless the engagement meets the requirements of subsection (1), this Article does not apply to engagements to make advances or to honor drafts or demands for payment, to authorities to pay or purchase, to guarantees or to general agreements.” U.C.C. § 5-102(2) (1978 version).

65. Section 5-102(3) contains a caveat:

(3) This Article deals with some but not all the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article.

U.C.C. § 5-102(3) (1978 version). This section provides flexibility for adaptation to new de-
Letter of credit, as well as other terms germane to the stand-by credit/guaranty controversy, are defined in section 5-103. The Code’s definition of letter of credit as an engagement that falls within the scope of Article 5, makes sections 5-102 and 5-103 interdependent. To be a stand-by letter of credit, the instrument must meet the definition of letter of credit. To meet that definition, the instrument must fall within the scope of Article 5. If it passes the acid test of form under sections 5-102(1)(a), (b) or (c), the instrument may be upheld as a stand-by letter of credit and not a development in commercial practice. The comments state “that in the present state of the law and variety of practices as to letters of credit, no statute can effectively or wisely codify all possible law of letters of credit without stultifying further development of this useful financing device.” U.C.C. § 5-102, Comment 2 (1978 version).

Some courts have considered this section, combined with Comment 2 and § 5-102(1)(c), allowing for “clean” letters of credit, to be statutory authority for the stand-by letter of credit. See, e.g., Republic Nat’l Bank v. Northwest Nat’l Bank, 578 S.W.2d 109, 113 (Tex. 1978), where the court noted that there was no “express statutory foundation” for the stand-by letter of credit; Barclays Bank v. Merchantile Nat’l Bank, 481 F.2d 1224, 1232 n.11 (5th Cir. 1973), cert. denied, 414 U.S. 139 (1974). The courts rely on the concerted effect of these provisions because the stand-by letter of credit is a recent newcomer to the commercial scene and the Code nowhere explicitly sanctions its use. However, reliance solely on these sections, especially § 5-102(1)(c), to justify the existence of the stand-by letter of credit is unnecessary and misleading. Section 5-102(1)(c) authorizes an instrument which does not meet the documentary form requirements of §§ 5-102(1)(a) or (b) — the “clean,” non-documentary credit. However, most stand-by credits do require documents as defined by § 5-103(1)(b). For examples of the documents required, see In Re Marine Distributors, Inc., 522 F.2d 791 (9th Cir. 1975) (endorsed promissory note and signed statement that beneficiary had presented promissory note to customer and had not received payment); Beathard v. Chicago Football Club, Inc., 419 F. Supp. 1133 (N.D. Ill. 1976) (signed affidavit that customer had not paid beneficiary’s wages for a football game); American Empire Ins. Co. v. Hanover Nat’l Bank, 409 F. Supp. 459 (M.D. Pa. 1976) (certificate that beneficiary had incurred an obligation under its surety bond issued on behalf of customer); Chase Manhattan Bank v. EquiBank, 394 F. Supp. 352 (W.D. Pa. 1975) (certificate that customer had defaulted on construction loan commitment and had failed to cure default); Dovenmuehle, Inc. v. East Bank, 196 Colo. 422, 589 F.2d 1361 (1978) (signed certificate that draft drawn covered loan balance); Edgewater Constr. Co. v. Percy Wilson Mortgage & Finance Corp., 44 Ill. App. 3d 220, 357 N.E.2d 1307 (1976) (signed certificate that monies were due and owing from customer on an FHA project); Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316 (1975) (signed statement that lessee had not paid rent installments).

These cases illustrate that § 5-102(1)(a) is often the “express statutory foundation” for the stand-by letter of credit.

66. Section 5-103(1)(a) of the U.C.C. (1978 version) provides:

(1) In this Article unless the context otherwise requires
(a) “Credit” or “letter of credit” means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor.
The analysis required to identify a bank's instrument as a stand-by letter of credit thus moves back and forth through sections 5-102 and 5-103. Section 5-102 begins, "This Article applies to a credit..." The definition of credit is found not in Section 5-102 but in Section 5-103(1)(a). A credit, or letter of credit, is an engagement entered into at the request of a customer to honor drafts or demands for payment that comply with specified conditions. Moreover, such engagement must fall within the scope of Article 5.

Here the analysis shifts back to Section 5-102(1)(a). For a bank issuer, the engagement, to fall within the scope of Article 5 as a letter of credit, must require a documentary draft or documentary demand for payment. "Documentary draft" and "documentary demand for payment" are defined in section 5-103(1)(b) as a draft or demand for payment which will be honored only if documents are presented. Section 5-103(1)(b) defines "document" as "any paper" and includes such examples as document of title, certificate, and notice of default.

Thus, section 5-102(1)(a), in conjunction with section 5-103, requires that the bank's instrument, to be a letter of credit, must be documentary in form. It must: first, be issued at the request of a customer; second, promise to pay a draft or a demand for payment; and third, be conditioned upon presentation of documents. If the instrument meets these formal requirements, it is a stand-by letter of credit and the analysis ends.

If, however, a documentary draft or documentary demand for payment is not required, this does not mean that the instrument is not a stand-by letter of credit. A final step in the analysis is necessary. Despite the lack of the documentary format, the instrument may be a stand-by letter of credit if, pursuant to section 5-102(1)(c), the instrument is entitled "letter of credit" or these words are conspicuously stated therein.

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68. "A 'documentary draft' or a 'documentary demand for payment' is one honor of which is conditioned upon the presentation of a document or documents. 'Document' means any paper including document of title, security, invoice, certificate, notice of default and the like." U.C.C. § 5-103(1)(b) (1978 version).
69. Id.
70. See note 61 supra. The Code defines "conspicuous" in § 1-201(10): "a term or clause
Judicial Application of Sections 5-102 and 5-103

Recent cases illustrate the courts’ first applications of sections 5-102 and 5-103 to the stand-by letter of credit in the face of a guaranty challenge. The cases reveal the courts’ willingness to analyze the Code in ways that will support the validity of this commercially useful instrument. They also provide insight into latent ambiguities in the Code which future judicial construction must resolve.

The most difficult instrument for the courts to identify is one that has no label and appears to be a bona fide guaranty. The courts have turned to sections 5-102(1)(a) and 5-103(1)(a) and (b) for guidance. The Code provides valuable assistance, but not without an interpretive struggle for the proper statutory construction of the words “document,” “documentary draft” and “documentary demand.”

In Bank of North Carolina v. Rock Island Bank,71 the defendant Rock Island Bank addressed a letter to its customer, stating, “We hereby issue to [customer], our irrevocable and unconditional commitment to purchase your Promissory Note of this date. . . .”72 Rock Island agreed to purchase the note from any holder in due course at maturity, and required from the holder sixty days’ written notice of its intent to sell the note to the bank. In its last paragraph the letter stated, “We hereby agree with the drawers, endorsers, and bona fide holders that this credit will be duly honored on presentation. . . .”73

Here, then, was a letter that was not conspicuously labeled a letter of credit, was not addressed to a beneficiary, but to a customer,74 did not require a draft for payment, and was not even

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71. 570 F.2d 202 (7th Cir. 1978).
72. Id. at 204.
73. Id.
74. This letter contained two obligations: a promise by the bank to its customer to purchase the customer’s note and a promise to any endorsers or bona fide holders to honor this commitment to purchase the note. Thus, the holders and endorsers were the beneficiaries of the letter; pursuant to § 5-103(1)(d) they were “entitled under [the] terms [of the credit] to draw or demand payment.” U.C.C. § 5-103(1)(d) (1978 version). Cf. Johnston v. State Bank, 195 N.W.2d 126, 130 (Iowa, 1972), where the court refused to uphold an instrument as a letter of credit because “[t]he essential element of a letter of credit which is absent here is a direct promise by the bank to pay the addressee of the letter” (emphasis
conditioned upon the default of the customer. The instrument did state that it was a credit, albeit inconspicuously in the body of the letter. It also created an engagement to pay drawers, endorsers and bona fide holders. The specified condition for payment was presentation of the promissory note.

On the same day the letter was issued, the customer signed a promissory note with another bank for the amount specified in the letter. This note eventually was purchased by the plaintiff, Bank of North Carolina, who, as a holder in due course, presented the note to Rock Island for payment in compliance with the terms of the letter. Rock Island refused to purchase the note, alleging that the letter was an illegal guaranty. The trial court found this letter to be "functionally indistinguishable" from guaranties held to be illegal by earlier Illinois courts, and it dismissed the complaint for failure to state a claim.

The Court of Appeals reversed. The court first recognized that letters of credit serve a guaranty function, but reasoned that enforcement should not be denied simply on that basis. The court then allowed that the "essential distinction" between a letter of credit and a guaranty is "purely formal" and drew a further distinction between a "true contract of guaranty" and a "guaranty" letter of credit": the obligation imposed by the latter is dependent on the presentation of documents, not upon the fact of default.

The court reviewed the definition of letter of credit contained in section 5-103(1)(a) and determined that a letter of credit must fall within the scope of Article 5. The court then turned to section 5-102 to determine whether Rock Island's letter met one of the three form tests. It found that the letter did not conspicuously state that it was a letter of credit, and that it was not so entitled. Thus, the

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added). In Johnston, the letter was addressed to a third party, but simply advised him of the bank's commitment to grant a real estate mortgage loan to its customer. In Rock Island, although the letter was addressed to the bank's customer, and not to a third party, it did contain a direct promise to pay third parties.

Rock Island's letter is akin to the general letter of credit, utilized in earlier times, which was addressed to no one person in particular and "confer[d] upon anyone who [would] act thereon the power of becoming a creditor of the issuer." Hershey, Letters of Credit, 32 Harv. L. Rev. 1, 11 (1918). The "special letter of credit," on the other hand, was addressed to a specific person who alone could draw on it. Id.

75. 570 F.2d 202, 205 (7th Cir. 1978).
76. See note 80 infra.
77. 570 F.2d 202, 206 (7th Cir. 1978).
78. Id., n.7.
letter did not fall within section 5-102(1)(c). However, the court construed the requirement of presentation of the promissory note as satisfaction of the need for a “documentary demand” under section 5-102(1)(a). The promissory note was the document, and its presentation the demand. The court, therefore, found the letter to be a letter of credit within the scope of Article 5, and not an ultra vires guaranty.

Judge Bauer wrote a strong dissent. He did not agree that the presentation of the promissory note constituted a documentary demand. Although he conceded that the promissory note was a document, he questioned how presentation of the note, which was a condition for honor of the demand, could also serve as a “demand for payment.”

There is merit to this argument. The confusion arises because section 5-103(1)(b) provides that a documentary demand for pay-
ment is a demand whose honor is conditioned on presentation of documents. Since presentation of documents is a condition precedent to honor of the demand, presentation cannot be equated with demand.82

The facts in New Jersey Bank v. Palladino83 were very similar to those in Rock Island. Like the letter in Rock Island, the instrument issued by the First State Bank of Hudson County was intended to secure a loan made by plaintiff New Jersey Bank to defendant Palladino, a customer of both banks. The letter, which did not mention the words "letter of credit," stated that it would "serve as a commitment to [New Jersey Bank] that [First State Bank] will assume the obligations arising from a note signed by [Palladino]. . . ."84 It conditioned honor of the commitment 90 days after date of the note upon notice that Palladino had defaulted on the loan.

Palladino defaulted on the note.85 It was unclear whether New Jersey Bank had demanded payment from the issuer before it

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82. Article 5 provides no definition for "presentation." It does define "presenter" as a "person presenting a draft or demand for payment for honor under a credit. . . ." U.C.C. § 5-112(3) (1978 version). Section 5-112(1) concerns a "bank to which a documentary draft or demand for payment is presented. . . ." U.C.C. § 5-112(1) (1978 version). The language of § 5-112 suggests that the demand for payment is separate from the presentation, since it is something which is presented.


84. Id. at 36, 389 A.2d at 456.

85. In fact, Palladino defaulted twice. When he defaulted on his first 90-day note, First Bank sought to avoid paying under its letter of credit by persuading the beneficiary, New Jersey Bank, to accept a reduction on Palladino's loan and renew the note. New Jersey Bank agreed and First Bank issued a second, identical letter covering the renewal. Nevertheless, Palladino defaulted again. Id.
failed and was taken over by the Federal Deposit Insurance Corporation. After the failure, New Jersey Bank sued both First Bank and Palladino for repayment of the loan. The trial court found the letter to be a guaranty.86

Relying on the scope and definition sections of Article 5, the New Jersey Supreme Court reversed and ruled the letter to be a bona fide stand-by letter of credit.87 The court explained that these sections describe a letter of credit as a bank’s agreement to honor written demands for payment upon compliance with specified conditions.88 It determined that the instrument met the section 5-102(1)(a) test by requiring a documentary demand for payment.89 Emphasizing the definition of document as “any paper,” including a notice of default,90 the court held the notice requirement to be a “documentary demand.” Although the letter on its face did not specify “written” notice, the court determined that since the parties were sophisticated businessmen and bankers, they knew a default must be in writing, and most probably intended that the notice be written.91 Because it met the form test of section 5-102(1), the letter was a letter of credit and not an illegal guaranty.92

However, unlike the court in Rock Island, the Palladino court did not expressly equate the presentation of the notice with the

86. However, because Palladino had used part of the loan proceeds to reduce his loans with First Bank, the trial court held that First Bank was estopped from raising the ultra vires defense. Judgment was entered against First Bank for the entire obligation. The appellate court held the letter to be a guaranty, illegal under New Jersey law, not a letter of credit within the scope of Article 5. The judgment for the entire obligation was vacated and replaced by a judgment for the amount First Bank had received in reduction of Palladino’s personal loans. 146 N.J. Super. 6, 368 A.2d 943 (1976).
88. Id. at 40, 389 A.2d at 458.
89. Id. at 42, 389 A.2d at 461.
90. Id. at 40, 389 A.2d at 458.
91. The dissent argued emphatically that the letter required no document, because it did not expressly require written notice. The court’s “attempt to bootstrap the validity of the document by resorting to the maxim that the law will imply an intent by the parties that the writing be construed in a manner such as to lend validity to it,” subverted the essence of the letter of credit as an obligation to pay against specified documents. 77 N.J. 33, 51, 389 A.2d 454, 464 (1978) (Conford, J., dissenting).
demand requirement. It is possible that the Palladino court considered the concept of “demand” to be implicit in the “notice” requirement, so that a written notice of default supplied both the document and the demand. By contrast, the Rock Island promissory note, of itself, did not constitute “notice” or a “demand.”

93. Other courts have had occasion to construe the requirement of a “documentary demand for payment” under § 5-102(1)(a) in the context of the stand-by letter of credit, although not on the guaranty question. The decisions offer no hope of a consensus. In contrast to Rock Island and Palladino, where the paper was found to serve as both the document and the demand, the paper in some cases was found to be a demand, but not a document.

In Brummer v. Bankers Trust, 268 S.C. 21, 231 S.E.2d 298 (1977), the instrument stated that it was a letter of credit and required only a signed statement from the beneficiary that it has incurred a liability due to the customer’s failure to take a construction loan committed to the customer by the beneficiary. The court held that the instrument was a letter of credit under §§ 5-102(1)(c) and 5-103(1)(a). The court apparently did not believe the statement alone met the documentary demand requirement of § 5-102(1)(a), since § 5-102(1)(c) applies only when the instrument does not fall within § 5-102(1)(a) or (b). See note 67 supra. However, the court also found that the beneficiary in fact had complied with the terms of the letter by demanding payment, and that the issuer incurred a legal obligation to honor the demand. Since the only condition for payment was the submission of the statement of default, the court evidently found that the statement was a demand for payment.

The court in Housing Sec., Inc. v. Maine Nat’l Bank, 391 A.2d 311 (Me. 1978) also relied upon § 5-102(1)(c) to bring the instrument in question under the Article 5 umbrella. The letter stated that it was a letter of credit and required written notice accompanied by the original letter of credit. The letter did not describe what information the notice should contain. The court explained in a footnote that the letter did not require a documentary demand for payment since the written notice was not a document within the meaning of § 5-103(1)(b). “Traditionally, a document, ‘like’ that described in § 5-103(1)(b), consists of a paper having evidentiary value of some fact.” Id. at 318 n.9. The written notice in this instance lacked any such evidentiary purpose. The court’s reasoning in Housing Securities does not help to explain the holding in Brummer, where the statement provided documentary evidence of the existence of the customer’s default.

Housing Securities may contain the seeds of a future construction of “documentary draft or documentary demand” which would flesh out the “any paper” definition to mean “any paper with evidentiary value.” A strict reading of the Code militates against such a construction. Comment 1 to § 5-102(1)(a) emphasizes that “paragraph (1)(a) . . . states that whenever the promise to honor is conditioned on presentation of any piece of paper, the transaction is within this Article. . . .” Such a construction would also create the further problem of defining “evidentiary value.”

This construction might, however, serve to characterize the use of the document as a “demand” in cases like Rock Island and Palladino, since the substance or evidentiary value of the statement could be construed as effecting a demand. See First Am. Nat’l Bank v. Alcorn, 361 So.2d 481 (Miss. 1978), where the court upheld an instrument as a letter of credit under § 5-102(1)(a) which did not state that it was a letter of credit, but required for payment presentation of an invoice approved by the customer. Although the letter did not request presentation of a draft accompanying the invoice, the court held that the instrument lay within the definition of documentary drafts under § 5-103(1)(b). The court in effect upheld the presentation of the approved invoice, which of course had “evidentiary value,” as a demand for payment. But see Dubuque Packing Co., Inc. v. Fitzgibbon, 599 P.2d 440 (Okla. Ct. App. 1979), where the court refused to uphold as a letter of credit a bank’s instrument which required for payment presentation of an unpaid invoice, a copy of correspond-
Both *Rock Island* and *Palladino* found the U.C.C. analysis useful in resolving the stand-by letter of credit identity crisis. They focused on the documentary format as provided by sections 5-103(1)(a) and (b) and 5-102(1)(a) as the basis for distinguishing the stand-by letter of credit from the guaranty.

**Application of Section 5-102(1)(c)**

When the stand-by instrument is entitled “Letter of Credit” or states that it is one, the courts have less difficulty in distinguishing it from a guaranty. Even if the credit requires a documentary draft or demand for payment, section 5-102(1)(c) is often relied upon to support its validity.

One of the earliest cases to apply section 5-102(1)(c) in a guaranty challenge to a stand-by letter of credit was *Barclays Bank v. Mercantile National Bank.*

Barclays granted its customer, a real estate developer, an interim construction loan. To induce Barclays to make the loan, the developer’s mortgage broker issued a letter to Barclays promising to pay the loan if the developer defaulted. The letter required for payment a sight draft drawn on the issuer, ninety days’ notice of intent to present the draft, and a signed statement from Barclays stating that the loan had matured, was past due, and remained unpaid.

After the borrower defaulted on the loan, Barclays presented its draft and the documents to both the issuer and Mercantile, the confirming bank. At trial, Barclays recovered against Mercantile.

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95. A confirming bank is a bank that engages to honor a credit issued by another bank. U.C.C. § 5-103(1)(f) (1978 version). This is a common practice among banks. Often, a buyer will not have a banking relationship with a major, money-center bank, but instead will bank locally. A seller may not be willing to rely on the unknown local bank’s letter of credit without further assurances. The local bank will often have a correspondent relationship with a larger, better-known bank which will agree to “confirm” the local bank’s letter of credit. The confirming bank “becomes directly obligated on the credit to the extent of its confirmation as though it were its issuer and acquires the rights of an issuer.” U.C.C. § 5-107(2) (1978 version). The seller now has two direct promises to pay under the letter of credit and may seek payment from either party. See Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461 (2d Cir. 1970); Dulien Steel Products, Inc. v. Bankers Trust Co., 298 F.2d 836 (2d
On appeal, Mercantile argued that the letter was a guaranty.

The Fifth Circuit first determined that the instrument fell within the scope of Article 5. Although the letter required a documentary draft in the form of a sight draft and a signed statement, it did not meet the section 5-102(1)(a) test because it was not issued by a bank. Section 5-102(1)(b) did not apply because the credit did not require documents of title. The letter was not even entitled letter of credit; however, there was a reference within the body of the instrument to “this letter of credit.” The court found that these words revealed the parties’ intent to treat the instrument as a letter of credit. The court also determined that the instrument met the section 5-103(1)(a) definition of letter of credit. Although the decision did not expressly rely on the section 5-102 form test to defeat the guaranty challenge, its analysis necessarily incorporated section 5-102(1)(c) to bring the letter within the scope of Article 5 from the outset.

By contrast, an “advising bank” only advises the beneficiary that a credit has been issued in its favor by another bank. Advising banks are used in international sales transactions where the issuing bank is located far from the beneficiary. An advising bank assumes no obligation to make payments to the beneficiary under the credit. U.C.C. § 5-107(1) (1978 version). See Bril v. Suomen Pankki Finlands Bank, 199 Misc. 11, 97 N.Y.S.2d 22 (Sup. Ct. 1950).

Mercantile sought to avoid its obligation as a confirming bank by advocating a strict reading of § 5-103(1)(f). Since the issuer of the letter was not a bank, but a mortgage broker, Mercantile argued that it could not be a confirming bank: it had not engaged to honor a credit issued by another bank. The court refused to read the Code so narrowly, citing Comment 2 to § 5-102(3) and the Code’s broad policy, which encourages courts to develop “new concepts to meet novel and diverse uses of the letter of credit.” 481 F.2d 1224, 1232 (5th Cir. 1973), cert. denied, 414 U.S. 1139 (1974).

The court did not discuss whether or not the words “letter of credit” were conspicuous as required by § 5-102(1)(c). See note 61 supra. They were not in larger type, and it is doubtful that they were of a different color within the body of a typed letter. However, they constituted a separate paragraph and so were set off from the paragraphs above and below them. Arguably, the words were conspicuous enough to fit the instrument within § 5-102(1)(c).

See also Housing Sec., Inc. v. Maine Nat’l Bank, 391 A.2d 311 (Me. 1978), where the court found that the words “letter of credit,” in the sentence “We hereby open our irrevocable Letter of Credit,” were “conspicuous” within the meaning of § 1-201.

In addressing the guaranty issue the court focused on Mercantile’s posture as a confirming bank. Section 5-107(2) provides that a confirming bank becomes “directly obligated on the credit... as though it were the issuer.” The court reasoned that since the issuer had a primary obligation on the instrument, rather than a secondary obligation as under a guaranty, the instrument was not a guaranty. This analysis begs the question whether the issuer’s obligation was in fact primary, since functionally it was secondary to the customer’s promise to repay the loan. That question had already been answered by the court’s finding...
Section 5-102(1)(c) was applied in response to a bank issuer's guaranty defense in Republic National Bank of Dallas v. Northwest National Bank of Fort Worth.\textsuperscript{98} Northwest Bank issued its letter, entitled "Irrevocable Letter of Credit," to secure a customer's promissory note payable to Republic Bank, the beneficiary. The letter required for payment a draft, the original promissory note, copies of letters sent by registered mail to the customer and others providing notice of default, and the registered receipts thereof dated no less than twenty days prior to the date of the draft. The trial and appellate courts held the letter to be an illegal guaranty, since it functioned like one by guaranteeing the debt of another.\textsuperscript{99} The Texas Supreme Court reversed and held the instrument to be a valid stand-by letter of credit.\textsuperscript{100}

The court began its analysis by placing the bank's instrument within Article 5, emphasizing the references to a "bank issuer" in sections 5-102(1)(a) and 5-103(1)(a).\textsuperscript{101} It determined that there were only two conditions precedent to payment: presentation of a draft and presentation of specific documents. The documentary format of the instrument persuaded the court that, although it appeared to create a secondary obligation, the letter in fact gave rise to a primary liability of the bank to the beneficiary. The court then turned to section 5-102(1)(c) and Comment 2 to section 5-102 for additional support,\textsuperscript{102} apparently unwilling to base its decision on the documentary format of the instrument alone. The court cited Barclays as a case which similarly relied on that section and Comment.\textsuperscript{103}

Once it determined that the instrument met the scope and definitional requirements of sections 5-102(1)(a) and 5-103(1)(a), the court should not have felt compelled to seek statutory authority for the stand-by letter of credit in section 5-102(1)(c). The Code itself provides that this section is to be applied only when the requirements of section 5-102(1)(a) or (b) are not met. Since section 5-102(1)(a) applied, dependence upon section 5-102(1)(c) was unnecessary.

\textsuperscript{98} 578 S.W.2d 109 (Tex. 1978).
\textsuperscript{100} 578 S.W.2d 109 (Tex. 1978).
\textsuperscript{101} Id. at 112-13.
\textsuperscript{102} Id. at 116. See note 61 and 65 supra.
\textsuperscript{103} Id. at 113.
The court's reliance on the Barclays' decision was equally inappropriate. The court in Barclays relied on section 5-102(1)(c) not because the instrument in question was a stand-by letter of credit, but because the letter was issued by a non-bank person and did not require a document of title. Since the letter did not meet the requirements of section 5-102(1)(a) or (b), the Barclays court properly predicated its holding on section 5-102(1)(c).

In United Bank of Denver National Association v. Quadrangle, Ltd., the court made short shrift of a bank's guaranty defense. The instrument in suit had been issued to secure a bond in a local court and required for payment a draft, a statement that the beneficiary submitted itself to the jurisdiction of the court, and a letter endorsed by the beneficiary. It thus met the requirements of section 5-102(1)(a). In addition, the instrument was conspicuously entitled a letter of credit. The court held the letter to be a primary obligation dependent solely on presentation of conforming documents, citing section 5-102(1)(c) as additional support.  

105. Id. at 409.
106. Id. See also East Bank of Colorado Springs v. Dovenmuehle, Inc., 196 Colo. 422, 589 P.2d 1361 (1978) and Prudential Ins. Co. v. Marquette Nat'l Bank, 419 F. Supp. 734 (D. Minn. 1976). In East Bank, the bank issuer did not expressly characterize its letter as a guaranty, but argued that the instrument was not a traditional letter of credit and therefore was not subject to Article 5. The court found that the bank's letter required a documentary demand pursuant to § 5-102(1)(a) (although, in fact, the letter required a draft and other specified documents), that the instrument conspicuously stated it was a letter of credit pursuant to § 5-102(1)(c) and that it fell squarely within the § 5-103(1)(a) definition.

It is unclear in Prudential whether or not the court relied totally on § 5-102(1)(c) to uphold the instrument before it as a valid stand-by letter of credit in the face of a guaranty challenge. The letter was issued by Marquette National Bank to cover a $62,000 commitment fee under a loan agreement between Prudential and its customer. Marquette agreed to pay Prudential the $62,000 if the customer failed to meet the conditions set out in the agreement and close the loan.

Marquette's engagement was predicated on a draft and a letter of default. When the loan failed to close, Prudential made demand on Marquette, submitting a draft and the appropriate letter. Marquette dishonored the draft and at trial raised the guaranty defense. The court began its analysis by quoting two misleading definitions. To establish that the letter was not a guaranty, the court cited the general guaranty definition: "A guaranty is a promise to answer for the payment of some debt...in case of the default of another person." 419 F. Supp. at 735. Frequently, a stand-by letter of credit performs exactly that function. The court further confused the issue by defining a letter of credit as conferring "authority upon the person to whom it is addressed to advance money or furnish goods..." Id. at 735. Marquette's letter conferred no authority to advance money or furnish goods. Rather, it promised to pay its customer's commitment fee if the customer failed to take the loan.

The court was ultimately persuaded that the instrument, which was labeled Irrevocable Credit, was a letter of credit within §§ 5-102 and 5-103. From the decision, it is unclear whether the court relied totally or only partially on § 5-102(1)(c).
In each of the cases discussed above, the courts relied upon the form tests in sections 5-102 and 5-103 to identify the instrument as a stand-by letter of credit and effectively thwart the guaranty challenge. Once the instrument in issue falls within the scope and definitions of Article 5, it is a letter of credit and can avoid the pitfalls of the *ultra vires* guaranty.

**The Limitations of Analysis Under Section 5-102(1)(c)**

The courts appear to agree that even a letter that requires no documentary draft or documentary demand may be considered a letter of credit if it states that it is one, as provided in section 5-102(1)(c).\(^\text{107}\) Taken to its extreme, however, this rationale can lead to incongruous results. In *Wichita Eagle and Beacon Publishing Co. v. Pacific National Bank of San Francisco*,\(^\text{108}\) the letter issued by Pacific National Bank was entitled "letter of credit," and required for payment presentation of a sight draft, but no documents. It advised the beneficiary that the draft would be honored "providing that all of the [stated] conditions exist at the time said draft is received. . ."\(^\text{109}\) by issuer. The conditions, relating to the failure of the customer to complete a construction contract, were listed in the letter. Upon default, the beneficiary presented the sight draft and documents evidencing the existence of the conditions, and Pacific refused to pay. The trial court rejected Pacific's guaranty defense and upheld the instrument as a valid stand-by letter of credit.\(^\text{110}\)

In a terse opinion, the Ninth Circuit reversed and held the letter to be a guaranty.\(^\text{111}\) The court found that the obligation was predi-

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\(^{108}\) 343 F. Supp. 332 (N.D. Cal. 1971), rev'd, 493 F.2d 1285 (9th Cir. 1974).

\(^{109}\) 343 F. Supp. at 341-42.

\(^{110}\) Id. at 339. Pacific argued that the letter was neither a "clean" nor a documentary credit, since one of the conditions did require documents, but others did not. The required documents were notices of default which the beneficiary had to send to the customer and others. However, the letter did not expressly require presentment of the notices to the bank along with the sight draft.

The trial court found that Pacific's "parochial" view "exalt[ed] formalism over commercial reality and usage." \(^\text{Id. at 338.}\) Although the U.C.C. had not yet been enacted in California at the time of the transaction, the court was persuaded by \(\text{§ 5-102(3)}\) and Comment 2 that the Code "clearly countenanced" this kind of credit. \(^\text{Id. at 339 n.4.}\)

\(^{111}\) 493 F.2d 1285 (9th Cir. 1974). To the bank's chagrin, the court of appeals upheld the guaranty challenge, and then proceeded to uphold the guaranty and to increase the award of damages by $87,000. The court did not explain this action. See discussion in Murray, *Letters of Credit in Non-Sale of Goods Transactions*, 30 Bus. Law. 1103, 1113-14 (1975).
cated not merely on the presentation of a draft or documents, but on the actual existence of most of the conditions listed in the letter. Therefore, it strayed "too far from the basic purpose of letters of credit." Although the court did not mention the U.C.C., the court, in effect, rejected a liberal construction of Section 5-102(1)(c). If the instrument requires the bank to determine the actual existence of stated conditions, it should be construed as an ordinary guaranty.

Courts and commentators have cited Wichita Eagle with approval, believing it to underscore the conceptual difference between the stand-by letter of credit and the guaranty. However, there is latitude within the Code to construe instruments such as the one issued by Pacific as letters of credit, if the parties intend to enter into such an agreement. Section 5-109 codifies the rule that the issuer of a letter of credit has a single, primary obligation to its customer: to examine documents and pay accordingly. An issuer has no liability for the performance of the underlying contract between the customer and the beneficiary "unless otherwise agreed." Since the Code thus allows banks to enlarge on their responsibility, a letter which embraces such an agreement but still satisfies the language of section 5-102(1)(c) arguably falls within the scope of Article 5. By this reasoning, the Ninth Circuit could have found the instrument in Wichita Eagle to be a valid letter of credit even though it did not limit the bank's responsibility to that of examining documents.

This analysis underlies the decision in CNA Mortgage Investors,

112. 493 F.2d at 1286.
113. The trial court also rejected reliance on § 5-102(1)(c) to support the issuance of a non-documentary credit, but only because it misread that section. Comment 1, the court explained, authorized banks and other persons "to bring documents other than documents of title within the coverage of Section 5-102." Wichita Eagle and Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332, 339 (N.D. Cal. 1971). In fact, the Comment also sanctions the issuance of "clean" letters of credit by banks. See note 62 supra.
115. U.C.C. § 5-109 states, in part: (1) An issuer's obligation to its customer...unless otherwise agreed, does not include liability or responsibility (a) for performance of the underlying contract for sale or other transaction between the customer and the beneficiary... (2) An issuer must examine documents with care... 
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_Ltd. v. Hamilton National Bank_,117 where the letter stated that the beneficiary's sight draft would be paid "in accordance with the terms of the [underlying] Loan Application attached hereto and becoming a part of this letter of credit."118 The bank dishonored the beneficiary's draft, contending that the beneficiary had not satisfied the prerequisite conditions. On the issue of whether a letter of credit may incorporate the underlying transaction, the court held that Article 5 specifically permits the parties to vary their obligations by agreement under a letter of credit.119 If the letter can be construed to permit an investigation into the underlying transaction, then the courts must abide by the intent of the parties.120

Because the loan application in question contained no provision relating to the payment of letters of credit, the court found no requirement that any document other than the sight draft need be presented and held the bank liable on the draft. The court did not explain how an instrument which required only a sight draft and no further documents could come within the scope of Article 5. Although the court did not expressly rely on the words "letter of credit" found within the body of the letter, the instrument probably qualifies as a section 5-102(1)(c) "clean" credit. If the court had determined that the issuer had in fact been obligated to investigate the underlying transaction, it would nevertheless have held the instrument to be a letter of credit. Such a letter would be indistinguishable from the one held to be a guaranty in _Wichita Eagle_.

Thus, the logic of the form test, taken to its extreme, suggests that a guaranty is not a guaranty when it is called a letter of credit. The court in _Wichita Eagle_ correctly discerned that treating an instrument like the guaranty in that case as a letter of credit would

118. _Id._ at 240.
120. CNA Mortgage Investors, Ltd. v. Hamilton Nat'l Bank, 54 S.W.2d 238, 242 (Tenn. Ct. App. 1975, cert. denied 1976). However, the court emphasized that "[i]n view of the documentary nature of letters of credit, very clear language would be necessary to require that something more than the presentation of specified documents is needed for payment." _Id._ at 243.
eliminate any distinction between the two.

An analysis of section 5-114(1) by Professors White and Summers suggests where the line should be drawn. They observe that although no fewer than fifteen subsections of Article 5 contain the phrase "unless otherwise agreed," the reigning principle of freedom of contract is not absolute. There may be some terms the parties might insert into a letter of credit that would be invalid. White and Summers cite 5-114(1) as "non-variable":121 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.122 Although a "clean" stand-by letter of credit requires neither goods nor documents, section 5-114(1) embodies the raison d'être for all letters of credit: non-involvement by the issuer in the actual facts of the underlying transaction. The subsection applies to stand-by letters of credit whether or not they require specific documents other than a draft for payment.

If this rule is "non-variable," then the parties cannot agree to modify its application and still be said to have entered into a letter of credit agreement. Thus, where section 5-102(1)(c), section 5-109, and section 5-114(1) conflict, the non-variability of section 5-114(1) should prevail.

CONCLUSION

Section 5-102 of the U.C.C. has been effectively employed to distinguish the valid stand-by letter of credit from the ultra vires guaranty. However, the courts have struggled in their efforts to enforce a commercially useful financial instrument because of their reluctance to uphold an apparently unlawful undertaking by a bank. This tension has led to occasional misapplication of section 5-102 and erroneous justifications for the legality of the stand-by letter.

A valid stand-by letter of credit requires no involvement by the issuer in the actual facts of the underlying transaction. The tests in section 5-102 express this rule and assist the courts in upholding the various forms of an instrument that the commercial world has widely adopted. As the courts become more comfortable with the stand-by letter of credit, they will rely less on section 5-102(1)(c)

121. White & Summers, supra note 119.
122. U.C.C. § 5-114(1).
and will apply section 5-102(1)(a) more frequently. Emphasis on the form test of section 5-102(1)(a) will encourage the courts to develop workable definitions for "document" and "documentary demand for payment." Once clearly defined and therefore easily recognizable, the stand-by letter of credit would shake off the guaranty stigma and take on the respectability of the traditional merchandise letter of credit.

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