Letters of Credit in Construction Projects

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With letters of credit, the “promise and premise are ‘pay now, argue later.’”1 Letters of credit are meant to provide payment security that is both certain and mechanical, even if there is a dispute between the parties. Although performance bonds are more prevalent in the construction industry, letters of credit offer owners and contractors advantages that performance bonds do not: Although performance bond sureties have no obligation to make payment unless a default has occurred, while banks that issue letters of credit typically must pay the beneficiary upon demand and without regard to the merits of a dispute concerning the underlying transaction.

Letters of credit are unique financial instruments, and the parties to any transaction involving letters of credit should be aware of the distinct body of law that governs them. The purpose of this article is to provide a basic understanding of letter of credit law, and insight into how letters of credit function in the construction context.

The Nature of Letters of Credit

Definition of Letter of Credit

A letter of credit is essentially a promise by a bank (the issuer) to pay a third party (the beneficiary) on behalf of a second party (the applicant). Article 5 of the Uniform Commercial Code defines a letter of credit as a definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant, or in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.2

Letters of credit operate as a promise to pay upon presentation of certain documents, provided the terms specified in the letter of credit are satisfied.3 There are different types of letters of credit. The most widely used types are “commercial” letters of credit and “standby” letters of credit.

Commercial Letters of Credit

For centuries commercial letters of credit have facilitated transactions for the sale of goods, particularly in international sales.4 The Second Circuit Court of Appeals has described the initial utility of commercial letters of credit as follows:

Originally devised to function in international trade, a letter of credit reduced the risk of nonpayment in cases where credit was extended to strangers in distant places. Interposing a known and solvent institution’s (usually a bank’s) credit for that of a foreign buyer in a sale of goods transaction accomplished this objective.5

Thus, in the typical arrangement, the buyer arranges to have a bank issue an irrevocable letter of credit to the seller. The bank will pay the seller only when the seller presents specified documents (e.g., proof that the goods were shipped). The bank will then turn to the buyer for reimbursement.6 Commercial letters of credit continue to be essential tools with widespread use in international trade.

Standby Letters of Credit

Unlike commercial letters of credit, where the issuer bank anticipates making payment if the parties perform, standby letters of credit provide security in the event of nonperformance of the underlying agreement.7 Standby letters of credit may be used in place of performance bonds.

At first glance, a standby letter of credit may appear identical to a surety bond or guarantee because all three are meant to provide recourse for default on an underlying agreement.8 Letters of credit, however, are
different and distinct from surety bonds. Surety bonds and guarantees are secondary obligations. A surety’s or guarantor’s obligation is contingent upon default of the underlying agreement. Thus, a surety or guarantor examines the underlying agreement and the relevant facts and circumstances to verify that a default has in fact occurred. Until the default has been factually established, there is no obligation to pay. A letter of credit is said to be a “primary” obligation. That is, the issuer’s obligation depends not upon the default itself, but upon the beneficiary’s presentation of particular documents. In fact, proof of the default is irrelevant to the obligation of a bank that has issued a letter of credit.

**Revocable Versus Irrevocable Letters of Credit**

Letters of credit may be either revocable or irrevocable. Although the issuer of a revocable letter of credit may unilaterally amend or cancel the credit at any time prior to the beneficiary’s presentation, once an issuer has established an irrevocable letter of credit, the issuer may not amend or cancel the credit without the beneficiary’s consent until the term set forth in the letter of credit expires. Letters of credit are presumed to be irrevocable unless the letter of credit expressly permits revocation.

**Clean Versus Documentary**

Most standby letters of credit are “documentary.” A “documentary” letter of credit requires that certain documentation accompany presentment of a draft for payment, such as a certificate of default. A “clean” letter of credit is payable upon the presentation of a draft; no accompanying documents are necessary.

**Legal Framework**

**Article 5 of the UCC**

Article 5 of the Uniform Commercial Code governs letters of credit issued in the United States, and even outside the United States if the parties so designate. It is particularly effective because it provides a uniform statutory scheme. Article 5 was revised in 1995, and most states have adopted the revised version.

**Uniform Customs and Practice for Documentary Credit (UCP)**

There are alternatives to the UCC’s article 5. In 1933, the International Chamber of Commerce (ICC), representing a consensus of the world’s banking community, created the UCP, or Uniform Customs and Practices for Documentary Credit. The UCP is a compilation of internationally accepted banking customs and practices regarding letters of credit. The UCP is not law, but instead “de facto law” that courts use because it reflects existing industry practice. Although typically the UCP must be expressly incorporated in the letter of credit in the United States for it to apply (thereby giving it binding effect as the “law” of the letter of credit), some courts may choose to apply the UCP to make up for gaps in the Uniform Commercial Code. Further, New York and other states have enacted legislation referring to the UCP as controlling a letter of credit transaction, rather than article 5, when the parties agree that the UCP will apply.

**International Standby Practices (ISP)**

The ISP, also drafted in part by the International Chamber of Commerce, provides detailed rules to govern standby letters of credit if the parties elect the ISP to apply. ICC Publication No. 590, “International Standby Practices 1998” (ISP98), is particularly popular in international transactions. ISP rules are more stringent than some of the other regulations of the ICC—for instance, with regard to the standard for presentation of documents for payment.


The UNCITRAL Convention on letters of credit came into effect in 2000 and applies primarily to international undertakings, including standby letters of credit. When the issuing bank is from a contracting country, the undertaking must expressly exclude UNCITRAL, or else it will apply. Application of the convention to a particular undertaking, however, does not exclude other sources of law. To the contrary, the convention specifically provides that where interpretation of the terms of the undertaking is not addressed by either the convention or the undertaking itself, then “regard shall be had to generally accepted international rules and usages of independent guarantee or standby letter of credit practice.” Sources such as the UCP and ISP 98 provide supplement, therefore, to the convention. Although the convention is generally consonant with the UCP, it differs from the UCP and ISP 98 in that it provides its own fraud rule, rather than leaving the issue to local law. At the time of this writing, the convention has limited applicability in that it has only been ratified by eight states.

**Case Law**

Case law is an important source, particularly because the UCC, UCP, ISP, and the UNCITRAL Convention do not contain sufficient detail to cover all situations.
**Elements of a Letter of Credit**

**Parties**

There are typically three parties to a letter of credit: the issuer, the applicant or customer, and the beneficiary.

- The issuer is the bank or other person that issues a letter of credit.  
- The applicant is the person or customer of the bank at whose request or for whose account a letter of credit is issued.  
- The beneficiary is the person who, under the terms of a letter of credit, is entitled to have a complying presentation honored.

**Issuance**

A letter of credit becomes legally enforceable upon issuance. Issuance occurs when the issuing bank transmits the letter of credit to the beneficiary. The credit may be issued in any form “that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties.” The instrument must be in writing and signed by the issuing bank.

**Timing and Fees**

Issuers often require applicants to pledge collateral to secure their promise to reimburse the issuer if the issuer has to honor the letter of credit. The customer may pledge acceptable securities accounts, as well as certificates of deposit from the bank, as collateral for a letter of credit. Although much depends on the customer’s relationship with its bank, the fees for a letter of credit are typically a small percentage of the letter of credit amount, plus a nominal processing fee. Typically, letters of credit can be issued in short time periods, following completion of a credit application or deposit of sufficient collateral.

**Drafting**

The form of a letter of credit is important. A letter of credit should indicate the following:

- that it is a letter of credit;
- that it is irrevocable;
- the amount of the credit;
- a place for presentation of documents;
- the exact identity of the beneficiary or beneficiaries;
- the documents required for payment;
- that payment will be made pursuant to a sight draft; and
- an expiration date, or automatic renewal.

Letters of credit typically have provisions relating to duration. If there is no stated expiration date, or other provision that determines its duration, a letter of credit expires one year after its stated date of issuance or, if no such date is stated, one year after the date on which it was actually issued. A letter of credit that states it “perpetual” expires five years after its stated date of issuance, or if no such date is stated, five years after the date on which it was actually issued.

**Presentment**

In letter of credit practice, presentment means the delivery of documents by the beneficiary to the issuer to obtain payment. A draft is a written order by which the party creating it orders the issuing bank to make payment under the letter of credit. Under letter of credit law, there are two types of drafts: sight and time. A sight draft is payable on presentment. A time draft is payable a certain number of days after presentment. The purpose of a time draft is to give the issuing bank time to review the documents presented to determine if they are in compliance with the letter of credit.

**Statement Required**

Standby letters of credit typically contain a condition requiring a statement upon presentment from the beneficiary that the applicant has not performed, it is in default, or the beneficiary’s liability has not been reduced. If the letter of credit is specific as to the form that the statement should take, most jurisdictions require that it be strictly followed.

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**Honor or Dishonor**

The bank is allowed a reasonable time to review the documents presented by the beneficiary before making payment. Under the UCC, the time cannot be beyond the end of the seventh business day from the date of its receipt of the presenting documents. Upon becoming aware of a deficiency in the documents presented for payment, the bank must give notice to the beneficiary and allow an opportunity to cure or remedy the noncompliant presentment before the credit expires. If the bank fails to provide timely notice of a defective presentment and thereby prevents the beneficiary from curing the defect before expiration of the credit, the bank may be estopped from raising the deficiencies or may be found to have waived any defense of failure to comply with the terms and conditions of the letter of credit. In some jurisdictions, and under some of the trade regulations, the issuing bank must provide clear and specific detail of the defect, or the notice of dishonor is not recognized.

The letter of credit creates an absolute, independent obligation, and payment must be made upon presentation of the proper documents, regardless of any dispute between the parties to the underlying agreement. Except for limited circumstances discussed below, the terms of the letter of credit, and not the external merits of an underlying
agreement, control an issuer’s liability. The issuing bank’s duty is confined to reviewing carefully documents that are presented against the terms of the letter of credit.

Crucial Principles
Two crucial legal principles govern letters of credit in the United States: the independence principle and the strict compliance principle. These principles exhibit the fundamental policies and values that inform the letter of credit transaction.

The Independence Principle
There are generally three agreements that form a letter of credit transaction. First, there is the underlying business deal between the applicant and beneficiary. Second, there is the letter of credit itself, a financial instrument between the issuer and the beneficiary. Third, there is a reimbursement agreement between the applicant and the issuer so that the issuer is compensated for the money it pays to the beneficiary.

One of the fundamental principles governing letters of credit is that they are independent of any of the other related agreements, which includes independence from the underlying business deal and from the reimbursement agreement. Put another way, the obligations of an issuer to a beneficiary are unaffected by, or independent from, “the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.”

This means that a breach, or alleged breach, of the underlying business agreement by either party has no effect on the duty of the issuing bank to honor a draw on the letter of credit when the terms and conditions of that letter of credit have been met.

The independence of the letter of credit from the reimbursement agreement is also important. An issuer must comply with its obligations under the letter of credit without regard to whether it will be reimbursed. This is the case even when the applicant becomes insolvent. Case law involving insolvent contractors naturally evolves from the misguided efforts of issuers to avoid payment when they know they will not be reimbursed. In Eakin v. Continental Illinois National Bank and Trust Co. of Chicago, the Seventh Circuit Court of Appeals addressed dishonor by an issuer when the contractor and the applicant surety were insolvent at the time of the draw. In holding the bank to the terms of the letter of credit, that court noted:

Letters of credit assure swift and reliable payment in commercial transactions. That promise was frustrated by [the issuer], which used flimsy pretexts to renege on a standby letter of credit supporting a construction contractor’s bond.

The surety that had issued a surety bond supporting the contractor’s performance on a reclamation project therefore was entitled to payment under the letter of credit. Although the issuer initially refused to honor the letter of credit, the independence principle prevailed, and the issuer was forced to pay the beneficiary.

No Duty to Investigate
Another attribute of the independence principle is the idea that the issuer has no duty to investigate the underlying business transaction before honoring a draw on the letter of credit. The issuer’s function is ministerial in nature in that it must honor a conforming demand on a letter of credit and has no duty to investigate the underlying transaction. Indeed, if the financial instrument is labeled “letter of credit,” but places a duty of investigation on the issuer, it may be outside the purview of article 5 of the UCC, and may only be a letter of credit by name.

Fraud or Forgery
One marked but narrow exception to the independence principle applies in cases of fraud or forgery. When there is fraud in either the underlying business transaction, or in the letter of credit transaction itself (e.g., forgery), the applicant may be able to obtain injunctive relief preventing the issuer from paying the beneficiary. Generally, when instances of fraud occur, “the issuer, acting in good faith, may honor or dishonor the presentation.”

The fraud exception to the independence principle is primarily limited by two concepts: (1) the fraud must be “material” before a court will enjoin the issuer from paying the beneficiary, and (2) the court must follow well-established equity principles before granting injunctive relief, and so it must not order equitable relief where there is an adequate legal remedy.

Strict Compliance
Strict compliance refers to the principle that any document presented by a beneficiary to an issuer must be in strict compliance with the terms and conditions of the letter of credit before the issuer will honor its obligations under the letter of credit.

Strict compliance does not require “slavish conformity to the terms of the letter,” nor “oppressive perfectionism,” but under the UCC is a concept derived from standard
The strict compliance standard as to the terms and conditions of the letter of credit “requires not only that the documents themselves appear on their face strictly to comply, but also that the other terms of the letter of credit such as those dealing with the time and place of presentation are strictly complied with.”

In one case involving the strict compliance standard, a court enjoined the issuer from honoring a letter of credit until it could be determined whether the beneficiary presented a “commercial invoice” as required by the letter of credit. The issue arose after the applicant unilaterally canceled the underlying business contract for construction of ministorage units, causing the beneficiary contractor to send an invoice for its “benefit of the bargain damages.” The court reasoned that to deviate from the strict compliance rule would undermine the certainty that makes the letter of credit so attractive.

Another aspect of strict compliance requires the beneficiary to comply with the time and place requirements in the letter of credit. Two cases with opposite outcomes illustrate this facet of the strict compliance standard. In the first case, the court held a beneficiary had acted within the terms and conditions of the letter of credit and therefore had made a timely presentation by appearing at the drive-up window of the issuer bank after normal hours when the bank’s lobby had closed.

In the second case, Consolidated Aluminum Corp. v. Bank of Virginia, the court held that the beneficiary was not entitled to payment under a standby letter of credit after the expiration of the letter of credit and therefore had made a timely presentation by appearing at the drive-up window of the issuer bank after normal hours when the bank’s lobby had closed.

The strict compliance standard was at one time challenged by a looser “substantial compliance” standard. This standard was generally based on a misunderstanding of letter of credit law and has now been widely rejected by courts and commentators alike.

Discrepancies and Notice
An issuer must dishonor a presentation that does not strictly comply with the terms and conditions of a letter of credit. If there are discrepancies, the issuer must not honor the letter of credit and also must give notice to the presenter of the discrepancies within “a reasonable time after presentation,” which cannot exceed seven business days after the receipt of the documents. If the issuer fails to give this notice, it will be liable for wrongful dishonor. However, the issuer may refuse to honor and draw upon a letter of credit on the basis of fraud, forgery, or presentation after the expiration of the letter of credit without providing notice to the presenting party.

Remedies and Defenses
Cause of Action by Beneficiary Against Bank for Wrongful Dishonor
Wrongful dishonor occurs when the issuer refuses the beneficiary’s presentation, and has no meritorious reason for dishonoring. It also can occur when the bank fails to honor the letter of credit or provide notice of discrepancies within the “reasonable time” set forth in UCC § 5-108(b).

Relief Available
Both the beneficiary and the applicant may recover damages from an issuer that has wrongfully dishonored a letter of credit. The beneficiary is entitled to “the amount that is the subject of the dishonor” plus “incidental but not consequential damages.” The applicant may recover “damages resulting from the breach, including incidental but not consequential damages, less any amount saved by the breach.” A party that is successful in proving wrongful dishonor by the issuer is also entitled to “interest on the amount owed” and “reasonable attorneys fees.”

Defenses of the Bank to a Cause of Action by the Beneficiary for Wrongful Dishonor
Typically an issuer or bank facing a wrongful dishonor action has only the following defenses: expiration of the letter of credit; discrepancies between the beneficiary’s presentation and the terms and conditions of the letter of credit; or fraud.

In a situation where an issuer asserts discrepancies as a defense, the beneficiary can argue that notice of the deficiencies in its presentation was inadequate. An entire trial may turn on whether an issuer that claimed discrepancies between the beneficiary’s presentation and the terms and conditions of the letter of credit gave proper and timely notice to the beneficiary. If a beneficiary makes a presentation close to the time of expiration of a letter of credit, the issuer will not be held to have acted in bad faith with respect to any dishonor based solely on the fact that the beneficiary was left with no time to cure its nonconforming presentation.

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The defenses of an issuer are limited, and the applicant or issuer may choose to waive defenses as to the draw, but in the absence of waiver, improper presentation by the beneficiary or fraud will protect the issuer against wrongful dishonor.

The Implications of Bankruptcy on a Letter of Credit
A chief benefit of being a beneficiary of a letter of credit is that the beneficiary’s rights under a letter of credit...
credit are relatively unaffected if the applicant files a petition in bankruptcy. This is because a letter of credit is not part of the bankrupt customer’s estate, and other bankruptcy laws may affect the issuing bank, but not the beneficiary.

Letters of Credit Are Not Property of the Estate Under Bankruptcy Code Section 541

Under section 541 of the Bankruptcy Code, when a bankruptcy case is commenced, an estate is created. The estate consists of “all legal and equitable interests of the debtor in property.” A beneficiary may draw on the proceeds of a letter of credit despite the fact that the customer that procured the letter of credit filed for bankruptcy protection. “The letter of credit is an independent third party obligation, and the proceeds are not the debtor’s property even if . . . the letter of credit is secured by the debtor’s property.” Although the automatic stay does not protect the debtor from draws upon letters of credit, it does insulate the debtor and its property. As a result, banks that have issued letters of credit to back surety bonds cannot enforce their rights against the debtor’s collateral that secures the debtor’s reimbursement obligation without relief from the automatic stay.

The Preference Section Is Also Unlikely to Apply

Generally, section 547(b) of the Bankruptcy Code provides for the trustee or a Chapter 11 debtor in possession to avoid (as an improper “preference”) transfers of the debtor’s property within 90 days of the bankruptcy filing.

In re M.J. Sales & Distributing Co., Inc. addressed whether honoring a letter of credit obtained by a debtor for the benefit of an unsecured creditor creates a preference when the bank honors the letter of credit after the debtor’s bankruptcy filing. The court held there is no such preference because the payment depletes the assets of the issuing bank and not the debtor. There are, however, at least some instances where the beneficiary’s draw on a letter of credit may be considered a preference.

Use of Letters of Credit Rather Than Bonds

The independence principle is at the heart of the advantages that letters of credit have over performance or surety bonds in the construction context. Under a performance bond, the owner must convince the surety that default has occurred, and the surety may independently investigate this claim—often leaving the owner to fund the dispute, and the construction project in a state of disarray. Further, the surety may oppose liability on the bond with a variety of defenses, and legal action on the part of the owner may only result in further cost and delay. Significantly, the surety will generally withhold payment to the owner until the contractor’s default is determined.

Contrast this situation with default that occurs and falls within the terms and conditions of a letter of credit. The issuer has no duty to investigate the alleged default, and must pay the owner absent fraud or forgery (or a noncomplying presentation). Even if the contractor alleges fraud or forgery, this may not prevent payment to the owner as the issuer may not wish to withhold payment. The contractor applicant would therefore be required to seek injunctive relief. However, in the construction context, breach of contract actions would provide an adequate legal remedy in most instances, meaning injunctive relief would be unavailable to the contractor. Further, in contrast to the performance bond context, an owner beneficiary of a letter of credit is able to hold on to the money from the letter of credit while any litigation ensues to determine whether there was nonperformance or default by the contractor, shifting the burden of litigation costs, at least initially, to the contractor.

Under letters of credit, contractors receive the benefit of guaranteed payment to the beneficiary once the terms and conditions of the letter of credit are met. Owners receive the benefit of payment prior to any litigation concerning the underlying contract. Letters of credit, however, often not drafted for the full contract price, may not provide the same scope of protection as surety bonds, because surety bonds are often issued for 100 percent of the contract price. Further, with surety bonds, separate payment (100 percent) and performance (100 percent) bonds are often used so that damages for both labor and material lien claims and performance obligations can be recovered.

Guiding Principles

The distinction between letters of credit and performance bonds is the independence principle, which makes the letter of credit stand alone from any other agreement. In both the drafting of a letter of credit and in any dispute involving a letter of credit, one must consider not only the independence principle, but also two other guiding principles of letter of credit law—certainty and risk allocation. By selecting a letter of credit, the beneficiary and applicant agree to the certainty of payment upon proper presentation of drafts to the issuer; the issuer seeks the certainty of not having to pay in instances of material fraud or improper presentation by the beneficiary. All parties receive the mechanical risk allocation under which the beneficiary is likely to be holding the money during the course of dispute proceedings.

Endnotes

2. UCC § 5-102(a)(10).
7. Id.
9. See UCC § 5-103, cmt. 1.
A surety is “one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.” . . . A surety bond is a “‘written instrument executed by the principal and surety in which the surety agrees to answer for the debt, default, or miscarriage of the principal.’” . . . In suretyship, the risk of loss remains with the principal, while the surety merely lends its credit so as to guarantee payment or performance in the event that the principal defaults. . . . In the absence of default, the surety has no obligation.

Id. at 38.


15. See Dolan, supra note 13, § 2.10(1).

16. UCC § 5-106(a).


19. Dolan, supra note 13, § 3.05.

20. The UCP received a recent update with the ICC’s release of UCP 600, which came into force on July 1, 2007.

21. Gao & Buckley, supra note 18, at 111.


23. Copies of the ISP and UCP rules may be obtained from the ICC through its website, www.iccwbo.org.

24. Gao & Buckley, supra note 18, at 98.


26. Id. art. 13.


28. See Convention art. 19 (providing for exception to the issuer's payment obligation for falsified documents and in situations where the demand has “no conceivable basis”); see Janet Koven Levit, Bottom-Up Lawmaking Through a Pluralist Lens: The ICC Banking Commission and the Transnational Regulation of Letters of Credit, 57 Emory L.J. 1147, 1180 (2008) (“UNCITRAL's Convention on Independent Guarantees and Stand-by Letters of Credit . . . not only incorporates the substance of several UCP provisions almost verbatim but also defers to ‘standards of international practice of independent guarantees or standby letters of credit.’”).


30. UCC § 5-102(a)(9).

31. UCC § 5-102(a)(2).

32. UCC § 5-102(a)(3).

33. UCC § 5-106(a).

34. UCC § 5-106.

35. UCC § 5-104.

36. UCC §§ 5-104, 5-102(a)(14).


39. For example: “It is a condition of this letter of credit that it shall be deemed automatically extended without amendment for one year from the present, or any future expiration date hereof, unless thirty days prior to any such date we shall notify you by registered letter that we elect not to consider this letter of credit renewed for any such additional period.”

40. UCC § 5-106(c).

41. UCC § 5-106(c) and (d). In Nat'l Surety Corp. v. Midland Bank, 551 F.2d 21 (3d Cir. 1977), a bank refused to honor a beneficiary's draw on a letter of credit stating that it was untimely, even though the letter of credit was supposed to be deemed automatically extended each year. The court held in favor of the beneficiary, finding that—as to timing—the credit renewed each year, and the drafts presented within two and a half years of issuance were within a reasonable time period.

42. UCC § 5-104(a).


44. Id.


46. Id.

47. See, e.g., UCC § 5-109; Colorado Nat'l Bank of Denver, 634 P.2d at 32.

48. UCC § 5-108(b). In Amwest Surety Insurance Co. v. Concord Bank, the surety, that was the beneficiary on a letter of credit posted as collateral for performance and payment bonds, sued the issuing bank for wrongful dishonor. 248 F. Supp. 2d 867, 871 (E.D. Mo. 2003). The surety prevailed on summary judgment, and the court based its decision in part on the failure of the bank to respond to the presentment of documents for 15 days. Even then, the bank failed to provide all of the reasons for the dishonor, and then never returned the presented documents.


50. Barclay's Bank v. Mercantile Nat'l Bank, 481 F.2d 1224 (5th Cir. 1973); Exchange-Mut. Ins. Co. v. Commerce Union Bank, 686 S.W.2d 913 (Tenn. 1984); see also UCC § 5-108(c) and (d).


52. First Empire Bank v. FDIC, 572 F.2d 1361, 1366 (9th Cir. 1978).

53. E. Girard Sav. Ass'n v. Citizens Nat'l Bank & Trust Co. of Baytown, 593 F.2d 598, 602 (5th Cir. 1979).

54. Am. Coleman Co. v. Intrawest Bank of Southglenn, 887 F.2d 1382, 1389 (10th Cir. 1989) (citing Marino Indus. Corp. v. Chase Manhattan Bank, N.A., 686 F.2d 112 (2d Cir. 1982)).


56. Amwest Sur. Ins. Co. v. Concord Bank, 248 F. Supp. 2d 867, 875 (E.D. Mo. 2003) (“The most fundamental principle of modern letter of credit law is that the three (3) contractual relationships giving rise to the letter of credit are completely independent of each other, and the rights and obligations of the parties to one are not affected by the breach or nonperformance of any of the others.”) (citations omitted).
over whether fraud in the underlying transaction protects the issuer. Some believe that only fraud or forgery relating to the presentation drafts or the letter of credit itself should allow the issuer to legally dishonor. For an article exploring this controversy and discussing the seminal case applying the fraud exception to the independence principle, see Henry Harfield, Enjoining Letter of Credit Transactions, 95 Banking L. 596 (1978).

67. UCC § 5-109(b) (“If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant . . . a court of competent jurisdiction may temporarily or permanently enjoin the issuer.”). This may even be the case under the UCP, where no specific provision on fraud exists. See Prairie State Bank v. Universal Bonding Ins. Co., 953 P.2d 1047, 1051 (Kan. Ct. App. 1998) (“We have examined the UCP in this regard and, while it does not specifically disallow a defense of fraud in the transaction, it also does not specifically provide for it either. We consider the UCP to be silent on the subject, and in such cases the UCC would apply.”).

68. UCC § 5-109(a)(1)-(2). However, “the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer’s or nominated person’s deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person.”

69. UCC § 5-109(b) (“If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant.”) (emphasis added).

70. UCC § 5-109(b)(3) (the court may only enjoin the issuer if “all of the conditions to entitle a person to the relief under the law of this State have been met”); see Barru, supra note 27, at 87–92 (discussing the materiality standard and the law governing injunctive relief in the context of fraud and letters of credit). Compare Prairie State Bank, 953 P.2d at 1049–52 (a rare case in which the narrow fraud exception to the independence principle was recognized in favor of the issuer), with W. Sur. Co. v. Bank of S. Oregon, 257 F.3d 933 (9th Cir. 2001) (more typical case in which court held that issuer wrongfully dishonored two letters of credit, and in which court’s ruling was based on a reading of the letters of credit, and that inquiry into the underlying business deal was proper).

71. UCC § 5-108(a). That section provides: Except as otherwise provided in Section 5-109, an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply with the terms and conditions of the letter of credit. Except as otherwise provided in Section 5-113 and unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear to so comply.

Id.; UCP 600 arts. 14–16; ISP 98 R. 4.01–4.19; see S. Energy Homes, Inc. v. AmSouth Bank of Alabama, 709 So. 2d 1180, 1187 (Ala. 1998) (“To invoke the fraud exception in this case would require an inquiry into the underlying contract, further disrupting the important commercial functions of credit law . . . . In this case, Southern Energy has an adequate remedy at law.”); UCP 500 art. 14.

72. UCC § 5-108 cmt. 1.

73. Id.

74. Atlas Mini Storage, Inc. v. First Interstate Bank of Des
Moines, 426 N.W.2d 686, 689 (Iowa Ct. App. 1988).
75. Id. at 687.
76. Id. at 688 (quoting First Nat’l Bank of Council Bluffs v. Rosebud Hous. Auth., 291 N.W.2d 41, 45 (Iowa 1980)).
77. UCC § 5-108 cmt. 1 ("[T]he section requires not only that the documents themselves appear on their face strictly to comply, but also that the other terms of the letter of credit such as those dealing with the time and place of presentation are strictly complied with."); see UCP 600 art. 14(j); ISP 98 R. 4.06.
79. Carter Petroleum, 97 P.3d at 509.
80. 544 F. Supp. 386; see also Tuthill v. Union Sav. Bank, 166 A.D.2d 702, 702–03 (N.Y. App. Div. 1990) (finding that beneficiary’s presentation after the letter of credit expired meant the bank did not wrongfully dishonor by not paying the beneficiary).
83. See Dolan, supra note 13, § 6.02 ("Departures from the strict discipline of letter of credit law are mistaken in adopting a rule that permits less than punctilious compliance by the beneficiary.").
84. UCC § 5-108(a); see also UCP 600 art. 16(a) (employing “may” dishonor); ISP 98 R. 4.01(a); UCP 500 art. 14(b).
85. UCC § 5-108(a). This is true unless the issuer agrees otherwise with the applicant or except as otherwise provided in § 5-113. Id.; see also UCP 600 art. 16(b); ISP 98 R. 5.05.
86. UCC § 5-108(b); see also UCP 600 art. 16(d) (providing notice must be made no later than close of the fifth banking day subsequent to the day of presentation); ISP 98 R. 5.01; cf UCP 500 art. 14(d)(i) (providing notice must be made no later than close of the seventh banking day subsequent to the date the documents were received).
87. UCC § 5-108(c); see also UCP 600 art. 16(f); ISP 98 R. 5.03; cf UCP 500 art. 14(c).
88. UCC § 5-108(d); see also ISP 98 R. 5.05.
89. See W. Sur. Co. v. Bank of S. Oregon, 257 F.3d 933, 937 (9th Cir. 2001) ("Inasmuch as the evidence offered by the Bank, even if accepted as true, does not support a conclusion that Western engaged in fraud in presenting the draft on Letter No. 192, there is no dispute of material fact on the issue. Consequently, the district court properly granted summary judgment to Western.").
90. See Amwest Sur. Ins. Co. v. Concord Bank, 248 F. Supp. 2d 867, 877 (E.D. Mo. 2003) (finding, where there was no fraud in the transaction, that the defendant bank had wrongfully dishonored by failing to give timely and adequate notice to the beneficiary of its reasons for dishonor).
91. UCC § 5-111(a)–(b).
92. UCC § 5-111(a).
93. UCC § 5-111(b).
94. UCC § 5-111(d)–(e).
95. Occidental Fire & Cas. Co. v. Continental Bank, N.A., 918 F.2d 1312, 1316 (7th Cir. 1990) ("Continental allegedly delayed too long before notifying Occidental of the nonconformity and failed to give adequate notice of the problem to the liquidator. The district court held a bench trial on this issue.").
96. See id. at 1317–18 (finding issuer was entitled to dishonor four separate nonconforming draw attempts by the beneficiaries of the letter of credit).
99. Id. at 941 (1994) (citing In re M.J. Sales & Distrib. Co., 25 B.R. 608, 615 (Bankr. S.D.N.Y. 1982)). In Keene, the debtor obtained several appeal bonds that it previously secured by letters of credit to various surety companies. Although the automatic stay prevented the continuation of asbestos-related litigation against the debtor, including the pending appeals; prevented the debtor’s banks from seizing the collateral backing the letters of credit; and prevented judgment creditors from satisfying their judgment against property of the estate, the automatic stay did not prevent or stay final judgment creditors from enforcing their judgments against the appeal bonds, nor did it stay or prevent the sureties from drawing the proceeds of the letters of credit in accordance with their terms.
100. 25 B.R. 608 (S.D. 1982).
101. Id. at 614.
102. See In re Air Conditioning, Inc. of Stuart, 845 F.2d 293, 299 (11th Cir. 1988) (distinguishing between payment of letter of credit and collateral pledged by debtor to secure letter of credit).
104. Id.
106. See supra notes 63–65 and accompanying text.
107. In many cases, the issuer would be wise to risk wrongful dishonor by making an independent determination as to whether there was fraud or forgery. See Eastland Bank v. Massbank for Sav., 767 F. Supp. 29, 35 (D.R.I. 1991) (finding that issuer bank’s fraud defense failed and that issuer was liable for face value of letter of credit plus 12 percent per annum interest from the time of the first wrongful dishonor).
108. See S. Energy Homes, Inc. v. AmSouth Bank of Alabama, 709 So. 2d 1180, 1187 (Ala. 1998) (“Clearly, a dispute exists between Southern Energy and GBH based on the underlying contract. However, ‘[f]raud claims should not become surrogates for breach of contract claims.’”)