

LETTERS OF CREDIT AND THE INSOLVENT APPLICANT:
A RECIPE FOR BAD FAITH DISHONOR

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I. INTRODUCTION

In a sale of goods contract, a seller (the beneficiary of a letter of credit) will require a buyer (the applicant of the letter of credit) to pay by means of a letter of credit in order to ensure that payment will be made. A commercial letter of credit is considered one of the most secure payment methods in international sales of goods.¹ A bank which issues the letter of credit assumes a direct obligation to pay the seller, as the beneficiary of the letter of credit, even if the buyer becomes insolvent or the market drops.² There is a caveat to the bank's obligation, however. Its obligation to pay is triggered when the seller/beneficiary presents documents that comply with the requirements of the letter of credit. If the seller's documents contain discrepancies, that is, if they do not comply strictly with the documents required by the letter of credit, then the issuing bank's obligation to pay under the letter of credit is extinguished.³ Nonetheless, from the seller's point of view, if she presents complying documents, the letter of credit will protect her against the risk of non-payment, particularly against the risk of the buyer's insolvency and the risk that a drop in market price will cause the buyer not to want the goods at the contract price.⁴

Letters of credit work most of the time.⁵ They are least likely to work, however, when the seller most needs protection, that is, when the buyer is

1. Gao Xiang & Ross P. Buckley, *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, 13 DUKE J. COMP. & INT'L L. 293, 293 (2003) ("The *raison d'être* of letters of credit is to provide an absolute assurance of payment to a seller, provided the seller presents documents that comply with the terms of the credit."). This Article will focus on commercial letters of credit, rather than standby letters of credit. Commercial letters of credit serve as a payment mechanism, while standby letters of credit function as a form of guarantee.

2. See Henry Harfield, *Who Does What to Whom: The Letter-of-Credit Mechanism*, 17 UCC L.J. 291, 292-93 (1985).

3. See Boris Kozolchyk, *Strict Compliance and the Reasonable Document Checker*, 56 BROOK. L. REV. 45, 50 (1990).

4. See Gerald T. McLaughlin, *Remembering the Bay of Pigs: Using Letters of Credit to Facilitate the Resolution of International Disputes*, 32 GA. J. INT'L & COMP. L. 743, 749 (2004). As a reminder of how a letter of credit works, think of a triangular relationship. At the three points of the triangle are the bank, the seller, and the buyer. The bottom leg of the triangle represents the underlying sales contract between the buyer and the seller. The seller requires the buyer to make payment by letter of credit. The buyer then applies to its bank (the top point of the triangle) for a letter of credit to be issued for the benefit of the seller. The buyer in the letter of credit transaction is thus frequently referred to as "the applicant" or "the account party," and the seller is referred to as "the beneficiary." The leg of the triangle between the buyer and the bank represents the agreement by the buyer to reimburse the bank if the bank pays the seller (beneficiary) under the letter of credit (reimbursement agreement). The leg of the triangle between the bank and the seller (beneficiary) represents the letter of credit, which the bank will honor if the beneficiary presents the documents which are required by the letter of credit. Each of the three agreements—sales contract, reimbursement agreement, and letter of credit—is considered separate and independent from the other two agreements. See David C. Howard, *The Application of Compulsory Joinder, Intervention, Impleader, and Attachment to Letter of Credit Litigation*, 52 FORDHAM L. REV. 957, 966-67 (1984).

5. Estimates are that the letter of credit fails to be honored in 1% or fewer cases. See James Byrne, *UPDATE Reader Survey Brings Out Reactions to Minor Discrepancies*, LETTER OF CREDIT UPDATE,

insolvent or there is a drop in the market price. This Article will focus on the letter of credit's failure to protect against buyer insolvency, and it will show how the letter of credit system provides an issuing bank with substantial discretion to deny payment under a letter of credit when it believes its customer, the buyer, is unable to reimburse it. The Article will also consider whether the bank's obligation to act in good faith should limit its discretion to deny payment to the seller under a letter of credit when the buyer is insolvent.

Scholarly attention has recently focused on the gap between the conventional wisdom about letters of credit as secure payment mechanisms,⁶ and the reality that letters of credit frequently do not secure payment, even though they are routinely paid.⁷ Professor Ronald Mann's empirical study of letters of credit found that documents presented did not conform to the letter of credit requirements 73% of the time.⁸ Other studies have suggested that the rate of non-compliance is even higher.⁹ When documents under the letter of credit contain discrepancies, that is, they are in some way different from the requirements set forth in the letter of credit, the bank is relieved of its obligation to pay under the letter of credit.¹⁰ Because a discrepancy will extinguish the bank's obligation to pay, one would expect a high percentage of letters of credit to be dishonored. Professor Mann also discovered, however, that in almost every case, the buyer promptly waived the discrepancies, thereby permitting payment under the letter of credit to occur.¹¹ Professor Mann's study is valuable in focusing on the puzzle of why sellers continue to use letters of credit, when in most instances they do not actually guarantee a right to payment.¹² Instead, the letter of credit's effectiveness depends upon the good will of the buyer to waive discrepancies.¹³ Because a seller's payment right vanishes if the discrepancies cannot be cured,¹⁴ in the

July 1987, at 14 [hereinafter Byrne, *Reactions to Minor Discrepancies*]; James Byrne, *Discrepancies Plaguing Banks' LC Operations, New Survey Leams*, LETTER OF CREDIT UPDATE, Dec. 1988, at 10 [hereinafter Byrne, *New Survey*] (revealing that despite the high discrepancy rate, the percentage of letters of credit dishonored was not greater than 1% because most discrepancies were either corrected by beneficiaries or waived by applicants).

6. See Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494, 2499-2500 (2000).

7. See *id.* at 2502-05; see also Kerry L. Macintosh, *Letters of Credit: Curbing Bad-Faith Dishonor*, 25 UCC L.J. 3, 3 (1992) (citing studies showing that "[u]p to 90 percent of documents initially presented for payment under letters of credit do not comply with stated terms and conditions for payment").

8. See Mann, *supra* note 6, at 2502.

9. See Macintosh, *supra* note 7; *infra* note 29.

10. See Mann, *supra* note 6, at 2496.

11. See *id.* at 2513-15.

12. Professor Mann concludes that the commercial letter of credit serves as a verification institution, "verifying to the seller the likelihood that the buyer will pay, and verifying to the government the legitimacy of the transaction." See Mann, *supra* note 6, at 2521.

13. See *id.* at 2496.

14. An incurable discrepancy would occur, for example, when the letter of credit requires a bill of lading to show that goods were shipped before a given date, and the bill of lading that the beneficiary presents shows the goods were shipped after that date. See, e.g., *Prutscher v. Fid. Int'l Bank*, 502 F. Supp. 535, 536 (S.D.N.Y. 1980) (citing *Old Colony Trust Co. v. Lawyers' Title & Trust Co.*, 297 F. 152

majority of documentary presentations, payment by the bank will occur only if a buyer waives any defects in the seller's presentation.¹⁵

Yet, in most cases, the letter of credit is ultimately paid. Only a small percentage of letters of credit actually fail to serve the purpose for which they were employed.¹⁶ Given the billions of dollars of trade carried out each year using letters of credit, however, that small percentage can be significant.¹⁷ It is certainly the source of much of the letter of credit litigation for wrongful dishonor.¹⁸

This Article will focus on those cases where the bank dishonors the letter of credit when the buyer/applicant—its customer—is insolvent. The bank's refusal to honor the letter of credit may occur even when the buyer has waived discrepancies in the documents. The significance of the problem highlighted by Professor Mann—that the letter of credit does not always provide assurance of payment—becomes most apparent in those instances where the letter of credit actually fails as a payment mechanism even though the seller has performed her obligations under the underlying sale of goods contract.¹⁹ The dishonor of a letter of credit can be devastating to a seller. If the buyer is in bankruptcy, the trustee will not waive discrepancies.²⁰ Therefore, unless the seller's presentation is of the rare, flawless variety,²¹ the letter of credit will fail as a payment mechanism.

(2d Cir. 1924)). A curable discrepancy could be, for example, a correctable error in description, such as the wrong code number for a particular item. If the discrepancy can be cured within the time frame established by the letter of credit, the seller will be entitled to payment. See Boris Kozolchyk, *The "Best Practices" Approach to the Uniformity of International Commercial Law: The UCP 500 and the NAFTA Implementation Experience*, 13 ARIZ. J. INT'L & COMP. L. 443, 451 (1996) (explaining bad faith practices of banks which prevent the curing of discrepancies in order to avoid payment).

15. If there were discrepancies which the buyer refused to waive, a bank that nonetheless honored the letter of credit would do so at its peril because it would no longer be entitled to reimbursement. U.C.C. § 5-108(a), (i) (1995). The reimbursement agreement only obligates the buyer to reimburse the bank if the bank pays over complying documents. *Id.*

16. See Byrne, *Reactions to Minor Discrepancies*, *supra* note 5.

17. See DOCUMENTARY CREDIT WORLD, Nov.-Dec. 2000, at 48-53. Commercial letter of credit activity for the second quarter of 2000 for the top U.S. commercial banks exceeded \$30 billion. Assuming only 1% of those letters of credit failed completely (and assuming the amount in question for letters that failed was not significantly different from letters that did not fail), there would be \$300 million involved in letters of credit gone astray. These figures do not include the letter of credit activity of foreign banks.

18. See, e.g., *Voest-Alpine Trading USA Corp. v. Bank of China*, 288 F.3d 262 (5th Cir. 2002); *Heritage Bank v. Redcom Labs., Inc.*, 250 F.3d 319 (5th Cir. 2001); *Amwest Sur. Ins. Co. v. Concord Bank*, 248 F. Supp. 2d 867 (E.D. Mo. 2003).

19. In this Article, I have adopted the convention of referring to seller/beneficiaries by the female pronoun, buyer/applicants by the male pronoun, and banks by the neuter pronoun.

20. See *Courtaulds N. Am., Inc. v. N.C. Nat'l Bank*, 528 F.2d 802, 804 (4th Cir. 1975) (discussing instance where a trustee in bankruptcy refused to waive discrepancies under letter of credit, even though similar or identical discrepancies in prior drafts under same letter of credit had been waived by the company prior to appointment of trustee in bankruptcy). In other cases, the buyer will waive discrepancies, but the issuing bank will refuse to waive. See *Bombay Indus., Inc. v. Bank of N.Y.*, No. 103064/95, 9817, 1995 WL 808811, at *3 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov. 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997).

21. In addition to studies estimating discrepancy rates as high as 90%, see *infra* note 29, there is much anecdotal evidence supporting this result. The author was told by the head of a letter of credit department of a large New York bank that whenever her document checkers received a flawless presentation of documents under a letter of credit, they immediately suspected fraud. Forged documents gener-

Part II of this Article will focus on the causes and consequences of letter of credit failure. Part III will consider certain conduct of the issuing bank which could be considered opportunistic, the incentives for such conduct, and the impact it has on the letter of credit process. Part IV will discuss the obligation of good faith imposed on issuing banks; the impact on this obligation of two important aspects of letter of credit law, strict compliance and the independence principle; and the different approaches to the good faith obligation taken in the United States and in civil law countries. Finally, Part V will consider the application of the good faith standard when a bank denies payment under a letter of credit because the applicant is insolvent. It will discuss a specific example of opportunistic conduct by a bank and consider whether the good faith standard can limit a bank's discretion to dishonor in such circumstances. The Article concludes that in cases of applicant insolvency, when a bank is likely to dishonor a letter of credit because it fears non-reimbursement, the bank's claim that it is dishonoring for other reasons should be carefully scrutinized. If the reasons asserted by the bank are pretextual, then it is not acting with honesty in fact. Evidence of pretext could establish a prima facie case of bad faith conduct that would allow the question of whether the bank properly dishonored the letter of credit to be determined by the trier of fact. Finally, holding a bank to a good faith standard of conduct in cases of applicant insolvency would strengthen the letter of credit process and provide an incentive to all banks to follow standard practices when dealing with letters of credit.

II. THE FAILURE OF LETTERS OF CREDIT: CAUSES AND CONSEQUENCES

A. *What Causes Letters of Credit to Fail?*

It is worth noting that the letter of credit is a product marketed by banks. The typical sales pitch banks make to potential customers is that the letter of credit is a prompt, secure, and certain payment mechanism in international trade.²² Banks assert that the reason payment under a letter of credit is assured is because the credit of the bank is substituted for the credit of the buyer.²³ Thus, even if the buyer becomes insolvent, the bank will still have the obligation to pay under the letter of credit, assuming, of course, that the proper documents are presented for payment.²⁴ The customer most likely to

ally perfectly match the documents required by the letter of credit. Fraudsters just present documents; they do not ship goods. *See also* Robert M. Rosenblith, *Seeking a Waiver of Documentary Discrepancies from the Account Party: Unexplored Legal Problems*, 56 BROOK. L. REV. 81, 85 (1990) (“[I]t is more likely that a drawing made by a dishonest beneficiary will be absolutely conforming. After all, if the documents are going to be fraudulent, the beneficiary will take pains to dot every ‘i’ and cross every ‘t.’”).

22. *See infra* notes 169-48 and accompanying text.

23. *Id.*

24. *See* Gerald T. McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 OHIO ST. L.J. 1197, 1207 (1989) (“[T]he issuing bank’s letter of credit obligation should be binding regardless of whether the applicant can reimburse the bank for any payments made

find this sales pitch appealing is a seller who has concerns about obtaining payment, perhaps because the anticipated sale is a one-shot transaction, or involves a new, unknown buyer, or a buyer about whom the seller has some reason to question his ability to pay.²⁵ Thus, the seller who requires a letter of credit is one who has made a judgment that she cannot take the risk of selling on open account. By using a more expensive payment term, she believes she will be better protected from the risk of non-payment. Assurance of payment is the message the bank has successfully delivered when it sells its product.

What, then, causes letters of credit to fail? Failure in this sense refers to the letter of credit's inadequate performance measured against the assertions made by the banks that it is a prompt, secure, and certain payment mechanism. Partial failure occurs when payment is substantially delayed, so that it can by no means be considered "prompt."²⁶ Total failure occurs when the bank dishonors the letter of credit, even though the seller has performed its obligations to the buyer in accordance with the underlying sales contract.²⁷ When failures occur, bankers assert that the cause is the beneficiary's discrepant presentation of documents.²⁸ However, it is clear from Professor Mann's study and other empirical studies that, although discrepancies are the norm, they are typically waived by the buyer.²⁹ Therefore, the reasons for letter of credit failure go beyond simply the presence of discrepancies.

Failures occur when discrepancies in the presentation of a performing seller are not waived. If buyers do not waive discrepancies,³⁰ the issuing bank will not pay under the letter of credit because the bank would have no right to reimbursement by the buyer if it paid over discrepant documents.³¹ Even if the buyer does waive discrepancies, however, a bank may nonethe-

under the credit.").

25. See Mann, *supra* note 6, at 2495.

26. See *infra* note 41.

27. 50 AM. JUR. 2D *Letters of Credit* § 73 (1964).

28. See *infra* Part V.A.1.

29. See *id.* at 2513; Byrne, *Reactions to Minor Discrepancies*, *supra* note 5 (stating that most survey participants estimated that 90% of presentations contained discrepancies); Byrne, *New Survey*, *supra* note 5 (citing seven bank surveys that found 30% to 90% of documents presented were discrepant but that most discrepancies were corrected or waived). See also SIMPLER TRADE PROCEDURES BD., LETTER OF CREDIT MANAGEMENT AND CONTROL: A MIDLAND BANK SURVEY ON ERRORS IN LETTER OF CREDIT DOCUMENTATION (1985) [hereinafter SITPRO STUDY]. The Simpler Trade and Procedures Board (SITPRO) is the trade facilitation agency of the U.K. See SIMPLER TRADE AND PROCEDURES BD., SITPRO: Simplifying International Trade, <http://www.sitpro.org.uk> (last visited Sept. 29, 2005). The Survey contains SITPRO's conclusions on the costs and risks of letter of credit errors and methods for reducing the errors. *Id.* (finding that discrepancies caused a 49% rejection rate for first presentation of documents).

30. Even though the seller has performed on the underlying sales contract, a buyer may refuse to waive discrepancies because of a deteriorating financial condition, a drop in the market price of the goods, or a deliberate fraud. While there are numerous instances of letter of credit fraud, a discussion of that subject is beyond the scope of this Article. For a recent article on fraud in letter of credit law, see Ross P. Buckley & Gao Xiang, *The Development of the Fraud Rule in Letter of Credit Law: The Journey so Far and the Road Ahead*, 23 U. PA. J. INT'L ECON. L. 663 (2002).

31. See *supra* note 15.

less make the decision that it will not waive them.³² This normally occurs only when the bank believes the buyer is insolvent and will not be able to reimburse the bank if it pays under the letter of credit.³³

The risk of the buyer's insolvency is what the seller thought she was avoiding by requiring payment by letter of credit. Yet, it is in exactly such a case when the letter of credit is most likely to fail, assuming discrepancies are found, because there is not likely to be a waiver of discrepancies.³⁴ Existing data suggests that the financial consequences of delayed payment and failed payment are significant.³⁵ As will be discussed in the next sections of this Article, this particular conundrum—why the letter of credit is most likely *not* to work in precisely those situations which the seller most needed it to work and expected it to work—is part and parcel of the original problem identified by Professor Mann: The letter of credit is simply not a secure payment mechanism.³⁶

B. Consequences of Failure

Professor Mann observed that the letter of credit system, if it worked perfectly, would provide a sorting mechanism based on seller's performance: complying documents would be presented by a seller who properly performed the underlying sales contract ("a performing seller"), and non-complying documents would be presented when a seller had not performed according to the underlying contract.³⁷ His study showed, however, that although discrepancies were frequent, they did "not generally suggest a serious failure of performance by the seller."³⁸ Yet, unless waived, those discrepancies would prevent payment to the seller under the letter of credit. The inevitable conclusion Professor Mann reached is that the disconnect between discrepancies and seller default indicates a problem with the letter of credit system.³⁹

That problem manifests itself when a performing seller fails to be paid under the letter of credit. While unexpected and unplanned delay in payment can create problems for a seller's cash flow, the complete failure of payment can wreak havoc. The seller generally requires payment by letter of credit because she made a decision that she cannot afford exposure to the risk of non-payment present when a sale is made on open account.⁴⁰ When

32. See U.C.C. § 5-108 cmt. 7 (1995). Banks take the position of the U.C.C. See *id.* ("Except as otherwise agreed with the applicant, an issuer may dishonor a noncomplying presentation despite an applicant's waiver.").

33. See Mann, *supra* note 6, at 2513 n.63.

34. See *id.*

35. See *infra* note 41 (describing letter of credit losses of British exporters).

36. See Mann, *supra* note 6, at 2495, 2519.

37. See *id.* at 2505.

38. *Id.* at 2504.

39. See *id.*

40. See Margaret L. Moses, *The Irony of International Letters of Credit: They Aren't Secure, but They (Usually) Work*, 120 BANKING L.J. 479, 479 (2003).

her “secure” payment device fails, she is probably worse off than a seller who was willing to risk non-payment by permitting a buyer to purchase on open account because that seller had made the judgment that she could afford the risk.⁴¹

When the buyer actually waives discrepancies, but the bank nonetheless refuses to waive because it believes the buyer does not have the financial resources to reimburse the bank if it pays under the letter of credit, the bank’s conduct raises questions of good faith.⁴² This Article focuses on possible bad faith by the banks under U.C.C. Article 5, rather than on the bad faith of the buyer, whose conduct on the underlying sales contract would be determined under U.C.C. Article 2.⁴³ Thus, the focus will not be on situations where the market has dropped or for some other reason the buyer does not want the goods at the agreed upon price, but rather, where the buyer’s insolvency or deteriorating financial situation causes the bank to believe that if it pays under the letter of credit, it will not be reimbursed by the buyer.

The seller has several options once the letter of credit fails. If the seller has in fact fully performed, even though there were discrepancies in the presentation of documents that were not waived, she still has a cause of action against the buyer for breach of the underlying contract.⁴⁴ The difficulty is the high cost of enforcing an international sale of goods contract.⁴⁵

41. If prompt payment does not ensue under the letter of credit, unplanned exposure will cause the seller to suffer a financial penalty. The cost to the seller of unplanned exposure can be high. Although few empirical studies have been done in the letter of credit field, a study published by Britain’s Midland Bank International, in conjunction with SITPRO, reported that once discrepancies were found in a letter of credit presentation, the average time for resolution of the issues, before payment could be made, was nineteen days, but in some individual cases, the delays extended for several months. *See SITPRO STUDY, supra* note 29, at 18. The study considered the value to the exporter of the loss of use of the money for that period and calculated that the annual cost of that delay to exporters in Britain was over 30 million pounds. *Id.* Professor Mann’s study appeared to indicate that waiver times were generally short, and in many cases, no more than one day, although in a few cases the delay was as long as four weeks; no average time was provided. *See Mann, supra* note 6, at 2514. The two studies, however, measured different variables. The SITPRO Study measured the number of unpaid days—the days payment was withheld while various methods were undertaken to resolve the discrepancies. Those methods included seeking a waiver, and in some cases, sending the documents for collection, correcting the discrepancies, seeking and receiving an amendment, or paying under an indemnity. The Mann Study measured the days it took the applicant to waive after being contacted by the issuer. *See Mann, supra* note 6, at 2514. Although the SITPRO Study did not attempt to explain the delays, it did state that “rejected documents give less scrupulous buyers an open opportunity for fraud or, default on payment. Alternatively they might ‘negotiate’ a reduced settlement, especially if the market is falling.” *SITPRO STUDY, supra* note 29, at 17. In Professor Mann’s study, one buyer negotiated a reduced settlement after discrepancies were found, permitting the letter of credit to be paid but for only 94% of the agreed amount. *See Mann, supra* note 6, at 2513.

42. *E.g., infra* note 65 and accompanying text.

43. *See* U.C.C. § 5-102 cmt. 3 (1995) (“The contract between the applicant and beneficiary is not governed by Article 5, but by applicable contract law, such as Article 2 or the general law of contracts. ‘Good faith’ in that contract is defined by other law, such as section 2-103(1)(b) or Restatement of Contracts 2d, § 205, which incorporate the principle of ‘fair dealing’ in most cases . . .”). U.C.C. section 2-103(1)(b) (Revised 2003) provides that “‘Good faith’ in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”

44. *See* Moses, *supra* note 40, at 481.

45. *See* Mann, *supra* note 6, at 2495.

If the seller has retained control of the goods and can resell them, either in the foreign country or in her home country after reshipping them to the port of origin, she is unlikely to sue the buyer, even though she will incur some losses.⁴⁶ The seller is also unlikely to sue the buyer if the buyer refused to waive the discrepancies because of insolvency, or if the seller is advised that the courts of the buyer's country do not provide due process and a reasonable chance of success.⁴⁷

Thus, the seller will be unlikely to engage in litigation if she has retained control of the goods and can recoup some of her losses by selling them to another buyer.⁴⁸ Litigation is most likely to occur, however, if the seller has not kept control of the goods through a negotiable bill of lading, and the buyer has taken possession of the goods, but the letter of credit is nevertheless dishonored.⁴⁹ In such a situation, the seller has lost not only the payment she could not afford to lose but the goods which she cannot now resell.⁵⁰ Her only chance for recovery will be through legal process. If the buyer is insolvent, the only practical recourse is against the bank.⁵¹ The next section of this Article will consider opportunistic conduct by banks whose applicant has become insolvent, the causes of such conduct, and the incentives to engage in it.

III. OPPORTUNISTIC CONDUCT

Because the high rate of discrepancies means many performing sellers lose their entitlement to payment, the letter of credit only works in the majority of cases when three things happen: the seller performs, the buyer acts in good faith to waive discrepancies, and the bank accepts the buyer's waiver and pays under the letter of credit.⁵² The disconnect between the seller's performance of the underlying sales contract and the seller's right to be paid under the letter of credit creates significant possibilities for opportunistic conduct on the part of banks.⁵³ When the seller loses the entitlement to be paid, banks can shift losses to the seller which would be borne by the bank if the letter of credit system worked perfectly (sorting sellers according to performance of the sales contract or lack thereof).⁵⁴ Opportunistic conduct, as used in this Article, thus refers to the actions of parties who thwart a seller's reasonable expectations of payment by taking advantage of the strict letter of credit rules to deny payment to a seller who has fully performed her

46. See Moses, *supra* note 40, at 486.

47. *Id.*

48. See *id.*

49. For a more in-depth discussion of the bill of lading as a control mechanism, see *id.* at 484-88.

50. See *id.* at 486.

51. *Id.*

52. See Margaret L. Moses, *The Impact of Revised Article 5 on Small and Mid-Sized Exporters*, 29 UCC L.J. 390, 392 (1997).

53. See Macintosh, *supra* note 7, at 10-11 (noting that an issuer has a powerful incentive to dishonor when customer is insolvent).

54. See Mann, *supra* note 6, at 2505.

obligations under the underlying sales contract but has presented documents that, although less than perfect under the letter of credit, would have been accepted absent buyer insolvency.⁵⁵

Opportunism can be quite subtle and can be easily masked as legitimate conduct.⁵⁶ It is viewed by scholars as inefficient, in the sense that if the parties considered the specific conduct prior to entering into the agreement, they would not allow it, since the behavior does not jointly maximize the parties' wealth.⁵⁷ As Professor Cohen has noted, "Opportunistic behavior produces no social benefits; instead of adding to the net wealth of society it merely redistributes wealth from one party to another."⁵⁸ Economists have also recognized that opportunism diminishes trust, which is a "valuable and vulnerable resource,"⁵⁹ and that, as a result, opportunistic behavior imposes large social costs.⁶⁰ Thus, opportunistic conduct is behavior that violates both a party's reasonable expectations based on the agreement, as well as societal norms.⁶¹ The focus of the rest of this Article is on opportunistic conduct by issuing banks in the face of buyer insolvency and the application of the U.C.C. Article 5 standard of good faith to such conduct.⁶²

55. This definition is consistent with the concept of opportunism as generally understood in law and economics literature; opportunistic conduct occurs when one party behaves contrary to the other party's understanding or expectation of their agreement but not necessarily contrary to the agreement's specific terms, leading to a transfer of wealth from the innocent party to the opportunistic party. Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521 (1981). Professor George M. Cohen defines opportunism as conduct "contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality." George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 957 (1992) (footnote omitted). Opportunistic conduct has also been described by Judge Richard Posner as "behavior designed to change the bargain struck by the parties in favor of the opportunist," including when a party invokes a provision "to achieve a purpose contrary to that for which the contract had been made." Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281, 280 (7th Cir. 1992). One of the most cited definitions of opportunism is that of Professor Oliver Williamson, stating that opportunism is "self-interest seeking with guile." OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47 (1985). Other scholars have defined opportunism as taking advantage of the other party's vulnerability. See Victor P. Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 AM. BEHAV. SCI. 337 (1980), reprinted in READINGS IN THE ECONOMICS OF CONTRACT LAW 16, 17 (Victor P. Goldberg ed., 1989).

56. See Cohen, *supra* note 55, at 956.

57. *Id.* at 957 (citing Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1139 n.118 (1981)); Muris, *supra* note 55, at 521. Letter of credit beneficiaries might be less likely to use a letter of credit if they understood how it actually worked when the applicant was insolvent, e.g., most documentary presentations are discrepant, and if the applicant becomes insolvent, the likelihood is that discrepancies will not be waived, and the beneficiary will not be paid despite its full performance under the underlying sales contract.

58. See Cohen, *supra* note 55, at 973.

59. *Id.* at 976.

60. See *id.* (citing KENNETH J. ARROW, *THE LIMITS OF THE ORGANIZATION* 26-27 (1974)); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (4th ed. 1992). Like criminal activity, opportunistic conduct violates social norms. See Cohen, *supra* note 55, at 973.

61. See Cohen, *supra* note 55, at 957.

62. This Article assumes that the "honesty in fact" standard is the appropriate standard of good faith to apply in letter of credit issues arising between the beneficiary and the bank. However, this narrow definition was adopted before revised Article 1 adopted a broader objective definition of good faith: "[H]onesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 2-103(1)(j) (Revised 2003). Revised Article 1 has been approved by the American Law Institute (ALI) and the National Conference of Commissioners of Uniform State Law (NCCUSL), but it has not yet been

The incentive for banks to engage in opportunistic conduct occurs when the bank learns, after it has issued the letter of credit, that its customer is insolvent and will not be able to reimburse the bank. Bank personnel then are motivated to review the documents presented under the letter of credit with a fine-tooth comb and assert any possible discrepancy they can find.⁶³ Some of these discrepancies have been rejected by courts, but others have been upheld.⁶⁴ In addition, when banks were concerned about the customer's ability to reimburse them, they have refused payment to the beneficiary even *after* their customer, the applicant, has waived the discrepancies.⁶⁵

Normally, the bank seeks the applicant's waiver to avoid the risk of the applicant's refusing reimbursement if the bank pays over discrepant documents.⁶⁶ Once the applicant has waived the discrepancies, however, a bank will typically honor the letter of credit.⁶⁷ There is no reason for the bank to refuse payment, once it knows that the discrepancies will not be used by the applicant to prevent reimbursement. The bank is required under the rules governing letters of credit, the UCP 500,⁶⁸ to base its decisions on the documents alone. These rules, therefore, do not permit the bank to refuse to pay for reasons outside of the documents, for example, its fear that the applicant will not reimburse it.⁶⁹

In other words, if banks have done an inadequate job of ascertaining and monitoring the creditworthiness of an applicant, and the applicant turns out to be insolvent, then opportunistic banks will attempt to shift the loss caused by applicant insolvency to the performing seller.⁷⁰ This loss, of course, is exactly the loss that the seller sought to avoid by using the letter of credit as a payment mechanism. The next sections of this Article will

adopted by most states. For an argument that the broader definition in Article 1 may affect the good faith obligations in Article 5, see Margaret L. Moses, *The New Definition of Good Faith in Revised Article 1*, 35 UCC L.J. 47 (2002).

63. See Kozolchik, *supra* note 3, at 53 ("Bad faith issuers usually rely on a hypertechnical examination [of documentary presentations] in order to prevent the loss that would otherwise result from their inability to obtain reimbursement . . ."). Professor Macintosh notes that, when an issuer learns its customer is insolvent, "[t]he issuer scrutinizes the documents for defects and asserts some relatively minor flaws as a basis for dishonor of the beneficiary's draft." Macintosh, *supra* note 7, at 11.

64. See *Voest-Alpine Trading USA Corp. v. Bank of China*, 167 F. Supp. 2d 940, 947 (S.D. Tex. 2000) (noting that minor discrepancies did not justify dishonor by bank), *aff'd*, 288 F.3d 262 (5th Cir. 2002). For examples of minor discrepancies being upheld by courts as justification for dishonor, see *Beyene v. Irving Trust Co.*, 762 F.2d 4, 6-7 (2d Cir. 1985); *Marino Indus. Corp. v. Chase Manhattan Bank*, 686 F.2d 112, 118-20 (2d Cir. 1982).

65. See, e.g., *Bombay Indus., Inc. v. Bank of N.Y. (Bombay III)*, No. 103064/95, 1997 WL 860671, at *1 (N.Y. Sup. Ct. 1997); *Bank of Seoul v. Norwest Bank Minn.*, 630 N.Y.S.2d 520, 522 (N.Y. App. Div. 1995); *Lectodryer v. SeoulBank*, 91 Cal. Rptr. 2d 881, 882 (Cal. Ct. App. 2000).

66. See Moses, *supra* note 40, at 482 n.2.

67. *Id.*

68. INT'L CHAMBER OF COMMERCE, I.C.C. UNIF. CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, Pub. No. 500, art. 14(b) (1993) [hereinafter UCP 500]. These rules are incorporated into almost all letters of credit. *Id.*

69. See *infra* Part IV.A.

70. See Macintosh, *supra* note 7, at 11.

consider the extent to which the obligation of good faith under letter of credit law can limit a bank's ability to engage in opportunistic conduct.

IV. THE OBLIGATION OF GOOD FAITH

There is no reference to good faith in the UCP, the rules which govern most letters of credit.⁷¹ The good faith obligation is thus determined by whichever national law is held to govern the letter of credit transaction.⁷² In the United States, Article 5 of the U.C.C., which governs letters of credit, provides that "[g]ood faith' [in this article] means honesty in fact in the conduct or transaction concerned."⁷³ This standard of good faith is considered to be narrow and subjective. It has been referred to as "the pure heart and the empty head" standard.⁷⁴ Courts have interpreted it to mean that so long as the *party* acted honestly, according to its beliefs or knowledge, its conduct would not be measured against more objective community standards of fairness.⁷⁵ The ordinary merchant, on the other hand, is held to a much broader, objective standard of good faith. Article 2 of the U.C.C. defines good faith in the case of a merchant to be both "honesty in fact and the observance of reasonable commercial standards of fair dealing."⁷⁶ In the last decade, this broader standard of good faith has also been incorporated into the revisions of U.C.C. Articles 3, 4, 4A, 8, and 9.⁷⁷ Because most U.C.C. articles have adopted this standard, revised Article 1 has changed the U.C.C. definition of good faith from the narrower standard to the broader one, except for Article 5.⁷⁸ Moreover, the proposed revision of Article 2 no longer

71. See *supra* note 68.

72. See Paolo S. Grassi, *Letter of Credit Transactions: The Banks' Position in Determining Documentary Compliance. A Comparative Evaluation Under U.S., Swiss and German Law*, 7 PACE INT'L L. REV. 81, 127 (1995).

73. U.C.C. § 5-102(7) (1995). Unless the parties agree otherwise, Article 5 will apply to any lawsuit where the confirming or issuing bank which is sued by the beneficiary is located in the United States. See U.C.C. § 5-116(b) (1995) ("[Unless otherwise agreed], the liability of an issuer, nominated person, or adviser for action or omission is governed by the law of the jurisdiction in which the person is located."). Although a confirming bank is not mentioned in this list, it is included by means of U.C.C. section 5-107(a) (1995), which provides that a confirmer "has the rights and obligations of an issuer to the extent of its confirmation."

74. Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 812 (1958) ("[T]his 'subjective' test, [is] sometimes known as the rule of 'the pure heart and the empty head . . .'").

75. See *Johnson & Johnson Prods., Inc. v. Dal Int'l Trading Co.*, 798 F.2d 100, 105 (3d Cir. 1986) (citing *Breslin v. N.J. Investors, Inc.*, 361 A.2d 1, 4 (N.J. 1976)) ("Under [the subjective] test, good faith is determined by looking to the mind of the particular [person], not what the state of mind of a prudent man should have been.").

76. U.C.C. § 2-103(1)(j) (Revised 2003).

77. See U.C.C. § 3-103 (1995); U.C.C. § 4-104(c) (1995); U.C.C. § 4-105(a)(6) (1995); U.C.C. § 8-102(a)(10) (1994), U.C.C. § 9-102(a)(43) (1999).

78. See U.C.C. § 1-102 (1990) ("'Good faith,' except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing."). Revised Article 1 has been approved by the ALI and the NCCUSL, but most states have not yet adopted it. For an update on state adoptions of Article 1, see Uniform Law Commissioners, *The National Conference of Commissioners on Uniform State Laws*, available at <http://www.nccusl.org/Update> (follow "Final Acts & Legislation" hyperlink; under "Select an Act," follow "UCC Article 1, General Provisions" hyperlink) (last visited Sept. 14, 2005).

imposes the broader standard on merchants alone but on any party to a sales transaction under the article.⁷⁹

Although both the narrow and broad definitions of good faith were considered by the drafting committee which revised Article 5,⁸⁰ the drafters refused to impose the broader standard of good faith.⁸¹ Representatives of the banks successfully advocated the continued use of the narrow honesty in fact standard.⁸² The bankers made three arguments in favor of the narrow standard: first, issuers need broad discretion and should not be bound to decide every case in the same way; second, the broad standard might dilute the strict compliance rule, effectively making it a substantial compliance rule; third, the broad standard might become a “runaway” good faith doctrine, which they asserted was a concern of Europeans and other non-Americans.⁸³ Thus, the main thrust of the bankers’ arguments appears to be that a broad good faith standard would undermine the right of the issuing bank to insist upon strict compliance, when it so desired, in order to deny payment under a letter of credit. Therefore, the doctrine of strict compliance and its role in the letter of credit transaction is important to consider with respect to good faith and opportunistic conduct.

79. U.C.C. § 2-103(k) (Proposed Official Draft 2002), available at <http://www.law.upenn.edu/bll/ulc/ucc2/annual2002.pdf> (“‘Good faith’ means honesty in fact and the observance of reasonable commercial standards of fair dealing.”) (stricken language in the original omitted).

80. Donald J. Rapson, *Who is Looking out for the Public Interest? Thoughts about the U.C.C. Revision Process in the Light (and Shadows) of Professor Rubin’s Observations*, 28 LOY. L.A. L. REV. 249, 273-75 (1994); Donald J. Rapson, *Why Revised Articles 5 and 9 Should Incorporate a Standard of “Good Faith” That Includes “Honesty in Fact” and “Reasonable Commercial Standards of Fair Dealing,”* U.C.C. BULL., Apr. 1995, at 1-6.

81. See Rapson, *Who is Looking Out for the Public Interest?*, *supra* note 80, at 273. Revisions of Article 5 were completed in 1995. Currently, all states but Wisconsin have adopted revised Article 5. See NCCUSL, *A Few Facts about the . . . UCC Article 5—Letters of Credit*, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ucca5.asp (last visited Sept. 15, 2005). A number of states have adopted non-uniform versions of Article 5, although the good faith provision appears to have been adopted uniformly. See *id.* For a discussion of some of the non-uniform adoptions of Article 5, see Margaret L. Moses, *The Jury-Trial Right in the U.C.C.: On a Slippery Slope*, 54 SMU L. REV. 561, 578-81 (2001).

82. See James J. White, *The Influence of International Practice on the Revision of Article 5 of the U.C.C.*, 16 NW. J. INT’L L. & BUS. 189 (1995). In this article, Professor White, the Reporter for Revised Article 5, explains the various negotiations during the drafting process that took place with the banking industry, as represented by U.S. Council on International Banking (USCIB). *Id.* at 194. At a point early in the process, the USCIB informed the NCCUSL that it was unhappy with the process and intended to withdraw and to publicize the reasons for its refusal to support the revisions. *Id.* at 194. n.13. To keep the bankers from campaigning to block adoption of the revised statute in state legislatures, Professor White negotiated with USCIB’s attorney, James G. Barnes, to revise the statute in ways acceptable to the banking industry. *Id.* at 194. Professor White noted that “many of the draft revisions arose out of bilateral negotiations between me, as representative of the Commissioners and Jim Barnes, as representative of the USCIB.” *Id.* The USCIB is now known as the International Financial Services Association. See IFSA Online, *One Voice for the Int’l Banking Operations Industry*, About IFSA (2001), <http://www.ifsaonline.org> (follow the “About IFSA” hyperlink) (last visited Sept. 13, 2005).

83. See White, *supra* note 82, at 205.

A. *Strict Compliance and the Independence Principle*

According to the standard practice of financial institutions that regularly issue letters of credit, an issuer must honor a presentation that “appears on its face strictly to comply with the terms and conditions of the letter of credit.”⁸⁴ But how strict is strict compliance? Some cases have required a “mirror image,” that is, the documents presented by the seller-beneficiary must exactly comply with the documents specified in the letter of credit.⁸⁵ Banks have tried to use the mirror image standard to deny payment. In *New Braunfels National Bank v. Odiorne*,⁸⁶ for example, the bank denied payment when a beneficiary submitted a draft under a letter of credit requesting payment on “Irrevocable Letter of Credit No. 86-122-5,” while the letter of credit specified that it was “Number 86-122-S.”⁸⁷ In that case, however, the court held that strict compliance does not demand oppressive perfectionism.⁸⁸

The Official Comment to Article 5 agrees with the position of the *New Braunfels* court: “Strict compliance does not mean slavish conformity to the terms of the letter of credit.”⁸⁹ Although strict compliance is not oppressive perfectionism, it is, nonetheless, not as broad as substantial compliance. Under the substantial compliance standard, a letter of credit can be honored even though there are some discrepancies in the documents, so long as the discrepancies are not misleading and do not appear to indicate seller default.⁹⁰ The substantial compliance standard has been generally rejected by most courts and by the Article 5 drafters.⁹¹

If strict compliance means neither perfect mirror image nor substantial compliance, then it must mean something in between. Although issuers are required to “observe [the] standard practice of financial institutions that

84. U.C.C. § 5-108(a) (1995).

85. See, e.g., *Beyene v. Irving Trust Co.*, 762 F.2d 4, 7 (2d Cir. 1985) (affirming summary judgment and upholding Irving Trust’s refusal to honor a letter of credit because, in the bill of lading, the name of the person to whom notice was to be given of the arrival of the goods was spelled “Soran” instead of “Sofan”). In applying a strict compliance standard, courts have frequently cited Lord Sumner’s statement in *Equitable Trust Co. of N.Y. v. Dawson Partners, Ltd.*: “There is no room for documents which are almost the same, or which will do just as well.” (1927) 27 Lloyd’s List L.R. 49, 52 (H.L.). See, e.g., *Alaska Textile Co. v. Chase Manhattan Bank*, 982 F.2d 813, 816 (2d Cir. 1992).

86. 780 S.W.2d 313 (Tex. Ct. App. 1989).

87. *Id.* at 316.

88. *Id.* at 318. The court also noted that “‘strict compliance’ means something less than absolute, perfect compliance.” *Id.*

89. U.C.C. § 5-108(a) cmt. 1 (1995).

90. See *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967), cert. denied, 390 U.S. 1013 (1968); *Crocker Commercial Serv., Inc. v. Countryside Bank*, 538 F. Supp. 1360, 1362-63 (N.D. Ill. 1981).

91. See, e.g., *Flagship Cruises, Ltd. v. New Eng. Merch. Nat’l Bank of Boston*, 569 F.2d 699, 705 (1st Cir. 1978); *U.S. Indus., Inc. v. Second New Haven Bank*, 462 F. Supp. 662, 665 (D. Conn. 1978). U.C.C. section 5-108(a) provides in pertinent part, “an issuer shall honor a presentation that, as determined by the standard practice . . . appears on its face strictly to comply with the terms and conditions of the letter of credit.” Official Comment 1 notes that “[t]he standard of strict compliance governs the issuer’s obligation to the beneficiary and to the applicant.” U.C.C. § 5-108(a) cmt. 1 (1995).

regularly issue letters of credit,"⁹² determining what that practice is may not always be an easy task, since standard practice may be written or oral, local or regional, and may vary from place to place. According to the Official Comment, standard practice includes:

(i) [I]nternational practice set forth in or referenced by the Uniform Customs and Practice, (ii) other practice rules published by associations of financial institutions, and (iii) local and regional practice. It is possible that standard practice will vary from one place to another. Where there are conflicting practices, the parties should indicate which practice governs their rights.⁹³

The Official Comment makes clear that the "standard practice" may not, in fact, be very standard. What becomes apparent is that, because issuers cannot draw exact lines as to what strict compliance is, in many cases they will have to use a certain amount of discretion.⁹⁴ In all cases, however, issuers are obligated to apply that discretion in good faith.⁹⁵

The banks' position generally is that the determination of whether or not the documents presented strictly comply with the requirements of the letter of credit should *not*, for the most part, be a matter of judgment or discretion.⁹⁶ The actual personnel of the bank who check documents under letters of credit—the document checkers—are not usually individuals who are highly educated.⁹⁷ The document checker's position is basically clerical, and the banks want the decision as to whether the documents comply to be largely ministerial.⁹⁸ The banks' position is that one of the reasons letters of credit are not more expensive is that banks can hire clerks rather inexpensively to check documents because a high level of judgment is not required.⁹⁹ All that the clerk is supposed to do is (1) look at the documents, (2) look at the requirements of the letter of credit, and (3) see if they match.¹⁰⁰ He or she is not supposed to interpret terms, or figure out if two

92. U.C.C. § 5-108(e).

93. U.C.C. § 5-108 cmt. 8.

94. Commentators have noted the difficulty of applying the same standard of strict compliance to different cases: "[I]t is impossible to be dogmatic or even to generalize [with respect to strict compliance]. Each case is to be considered on its merits and the bank's obligation may obviously be most difficult to fulfill." H. C. GUTTERIDGE & MAURICE MEGRAH, *THE LAW OF BANKERS' COMMERCIAL CREDITS* 120-21 (7th ed. 1984). The International Chamber of Commerce (ICC) has recently adopted, however, *International Standard Practices for the Examination of Documents*, ICC Publication No. 645, in an attempt to give more guidance to banks about standard practice.

95. See *infra* notes 247-253 and accompanying text.

96. See John Dolan, *Letter-of-Credit Disputes Between the Issuer and its Customer: The Issuer's Rights under the Misnamed "Bifurcated Standard,"* 105 *BANKING L.J.* 380, 382 (1988).

97. See Margaret L. Moses, *The Uniform Commercial Code Meets the Seventh Amendment: The Demise of Jury Trials Under Article 5?*, 72 *IND. L.J.* 681, 699 (1997).

98. See Dolan, *supra* note 96, at 395 ("The commercial speed and certainty necessary to the credit presuppose that the issuer's duties under the credit are ministerial. It is axiomatic that if the issuer must exercise discretion, there will be neither speed nor certainty.").

99. Moses, *supra* note 97, at 699.

100. *Id.*

terms are substantially equivalent.¹⁰¹ Any use of discretion, according to the banks, would adversely impact both the speed and the certainty of the letter of credit as a payment mechanism.¹⁰²

The banks' view of their overall function in the letter of credit transaction is that they are facilitating payment mechanisms, not resolving disputes regarding quantities or qualities of goods, late shipments, or other issues in the underlying contracts.¹⁰³ Banks do not want to assume an obligation to investigate or verify anything concerning the underlying contract, and they view strict compliance—the stricter the better—as permitting them to keep their role focused on the letter of credit documents. The UCP makes clear that “[i]n [c]redit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate.”¹⁰⁴

For this reason, the independence principle is viewed by banks as a very important underpinning to the doctrine of strict compliance.¹⁰⁵ According to this principle, each of the three agreements involved in a letter of credit transaction is independent of the others.¹⁰⁶ Those three agreements include the underlying sales contract between the buyer and the seller, the reimbursement agreement between the buyer and the issuing bank, and the letter of credit agreement between the issuing bank and the seller.¹⁰⁷ Application of the independence principle means that the agreement between the buyer and the seller (the underlying sale of goods contract) is not to be considered when the issuer determines whether the documents presented under the letter of credit strictly comply. The independence principle equally prevents the reimbursement agreement between the buyer and the bank from having

101. See Dolan, *supra* note 96, at 395.

102. See *id.*

103. See *id.*

104. UCP 500, *supra* note 68, at art. 4.

105. See Mann, *supra* note 6, at 2500.

106. International transactions usually include at least four agreements because there will be an agreement between the issuing bank (in buyer's country) and the paying bank (in seller's country) regarding reimbursement from the issuing bank to the paying bank once the paying bank has made payment to the beneficiary under the letter of credit. This type of bank reimbursement agreement is beyond the focus of this Article.

107. U.C.C. § 5-103(d) (1995) provides:

Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of 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.

The UCP 500, *supra* note 68, establishes the independence principle in Article 3:

(a) Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfill any other obligation under the Credit, is not subject to claims or defenses by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.

(b) A Beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank.

any effect on whether or not the letter of credit is honored.¹⁰⁸ Each separate agreement is supposed to be carried out according to its own terms, without regard to what occurs in the other two agreements.¹⁰⁹

Considering the way letters of credit actually work most of the time, however, the independence doctrine is more theoretical than real. The reason almost every letter of credit requires the seller to present the bill of lading and the commercial invoice as a condition of payment is that these documents provide evidence that the underlying contract was actually *performed* by the seller.¹¹⁰ Waivers by the buyer, which occur in most of the discrepant presentations, are based on the buyer's belief that the seller has satisfactorily performed her contractual obligations.¹¹¹ So the parties are not, in fact, acting completely independent of the underlying transaction. Instead, the performance of the contract by the seller, or at least the buyer's belief that the seller has performed, impacts heavily upon the buyer's willingness to waive discrepancies and thereby permit payment under the letter of credit.¹¹² Thus, the independence doctrine has no real significance when a solvent good faith buyer and a performing seller carry out payment by letter of credit. Rather, the independence principle appears to be part of the "end-game" norms,¹¹³ that is, it comes into play when a relationship breaks down entirely and one party needs a reason *not* to consider whether the underlying transaction was performed. If all parties know that the underlying transaction was performed—for example, the buyer has received the goods, and made no complaint about them—then there must be some reason outside of the actual letter of credit transaction for the letter of credit not to be paid. Normally, a bank will use the independence principle to assert that if complying documents have not been presented, it has no obligation to honor the

108. See Mann, *supra* note 6, at 2500-01.

109. There is an exception for fraud upon the applicant by the beneficiary that may require the issuer to look at the underlying contract. This narrow exception is limited to material fraud (U.C.C. § 5-109 (1995)) and is interpreted by courts to mean fraud that vitiates the transaction. See, e.g., *Harris Corp. v. Nat'l Iranian Radio & Television*, 691 F.2d 1344, 1354-56 (11th Cir. 1982) (discussing the breadth of fraud needed to nullify the transaction). Generally, an applicant must get a court order to stop an issuer from honoring a letter of credit when complying documents are presented. U.C.C. § 5-109(b). This is true even if there is fraud in the underlying transaction or in the documents. *Id.* This is a complex area, however, and an in-depth consideration of letter-of-credit fraud is beyond the scope of this Article. See *supra* note 30.

110. See Avery Wiener Katz, *Informality as a Bilateral Assurance Mechanism*, 98 MICH. L. REV. 2554, 2565 (2000).

111. See Jacob I. Corré, *Reconciling the Old Theory and the New Evidence*, 98 MICH. L. REV. 2548, 2550 (2000).

112. *Id.*

113. Both Professor Avery Katz and Professor Jacob Corré, who have written articles commenting on Professor Mann's article, suggest that the formal, strict rules of letter of credit transactions are rules likely to be applied in an end-game situation. See Corré, *supra* note 111, at 2550-51 (citing Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996)); Katz, *supra* note 110, at 2568-69 (citing Lisa Bernstein, *Formalism in Commercial Law: The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999)). According to this theory, the parties place conditions in their contracts that they expect to waive if everything proceeds as expected. See Katz, *supra* note 110, at 2569 (citing Bernstein, *Formalism in Commercial Law, supra*). The specific conditions imposed are end-game norms, which the parties only intend to invoke if there is a breakdown in the relationship. *Id.*

letter of credit because the independence principle prevents it from considering whether the underlying transaction has actually been performed.¹¹⁴ As will be discussed further in Part V, however, a court should also consider whether a bank has violated the independence principle when it refuses to honor the letter of credit because it fears its reimbursement agreement with the applicant will not be upheld due to applicant insolvency.

Because the strict compliance rule does not function in an ideal way, that is, by separating sellers who perform (and therefore should be paid) from sellers who do not perform (and therefore should not be paid),¹¹⁵ perhaps a closer look at the usefulness of the strict compliance rule is warranted. Bankers and many academic commentators take the position that using the strict compliance standard to determine whether a letter of credit should be honored is essential for the letter of credit to function as an efficient, prompt, and certain payment mechanism.¹¹⁶ Many courts have also adopted this perspective.¹¹⁷ Yet, there is no empirical evidence supporting this position. No study has shown that strict compliance, as opposed to substantial compliance, in fact promotes promptness, certainty, or efficiency.¹¹⁸

The strict compliance standard that sellers must meet to be entitled to payment seems particularly inappropriate and particularly likely to lead to inefficiency and delay, in light of the fact that an issuing bank can provide in its reimbursement agreement that the buyer must reimburse the bank so long as the bank pays over *substantially* complying documents.¹¹⁹ The drafters recognized this practice in the Official Comment, noting that “issuers can, and often do, contract with their applicants for expanded rights of reimbursement. Where that is done, the beneficiary will have to meet a more stringent standard of compliance as to the [bank] than the [bank] will

114. See Mann, *supra* note 6, at 2500.

115. *Id.* at 2505.

116. See John F. Dolan, *Strict Compliance with Letters of Credit: Striking a Fair Balance*, 102 BANKING L.J. 18, 26-27 (1985); Macintosh, *supra* note 7, at 7 (“By enabling the issuer to decide quickly, cheaply, and confidently which presentations must be honored, the strict compliance standard encourages the issuer to provide letters of credit at low cost, and assures the beneficiary of prompt, reliable payment.”).

117. See, e.g., *Voest-Alpine Int’l Corp. v. Chase Manhattan Bank*, 707 F.2d 680, 682-83 (2d Cir. 1983) (“Adherence to this rule [strict compliance] ensures that banks, dealing only in documents, will be able to act quickly, enhancing the letter of credit’s fluidity.”).

118. Data that are available tend to suggest the contrary. The SITPRO Study, which indicated that it took nineteen days to resolve a discrepancy, suggests that a less-strict standard of finding discrepancies would provide a more efficient, prompt, and certain payment mechanism. SITPRO STUDY, *supra* note 29, at 14-15, 18. Since, in both the SITPRO Study and the Mann Study, virtually all of the discrepant presentations were eventually paid, it does not appear that sellers often default in serious ways on the underlying contract. See *id.*; Mann, *supra* note 6. Rather, the disconnect between performing sellers and the presentation of complying documents seems to be rendering the letter of credit mechanism less efficient, prompt, and certain than it could be if a substantial compliance standard were applied, under which fewer discrepancies would be found.

119. See Kozolchyk, *supra* note 3, at 47 (noting that issuing banks include provisions in their agreements with applicants that authorize reimbursement even if there are discrepancies). See also *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968); *Crocker Commercial Serv., Inc. v. Countryside Bank*, 538 F. Supp. 1360, 1362 (N.D. Ill. 1981).

have to meet as to the applicant.”¹²⁰ There appears to be no good reason for this asymmetry of standards other than advantaging the banks. If the banks that entered into such agreements with the applicants paid the beneficiaries under a substantial compliance standard, they would also be reimbursed by the applicants based on the same standard. This should encourage prompt and efficient payment. The Official Comment sheds no light on why different standards are the norm. Holding the seller to a higher standard creates greater difficulty for the seller to obtain payment, and thereby, undercuts the letter of credit as a prompt, secure, and certain payment mechanism. This double standard for documentary compliance, however, greatly strengthens the bank’s hand during the end game, after the letter of credit has failed completely as a payment mechanism.

B. Good Faith Under Article 5

Considering that strict compliance is not “oppressive perfectionism,” standard practice is not always standard, and banks can waive non-complying documents, it is apparent that banks have a certain amount of discretion in determining whether to pay under a letter of credit.¹²¹ Under Article 5, banks are obligated to carry out their duties in good faith,¹²² and that good faith requirement extends to the discretion they use in carrying out these duties. Thus, it is useful to focus on what constitutes good faith under Article 5. As noted above, the drafters rejected the broad good faith standard in favor of retaining the narrower, subjective, “honesty in fact” test.¹²³ It is important to consider, therefore, what “honesty in fact” means and what impact it may have on conduct by banks.

120. U.C.C. § 5-108 cmt. 1 (1995). Here, there appears to be a conundrum similar to the payment-assurance story questioned by Professor Mann’s empirical study. *See* Mann, *supra* note 6. Why is strict compliance considered essential to prompt, efficient, and certain payment, when common sense suggests a substantial compliance standard would better accomplish these goals by reducing discrepancies and making a better fit between seller performance and complying documents? Certainly, more empirical studies such as Professor Mann’s should be able to shed light on this puzzle. It would be helpful, for example, to have studies of whether the discrepancies that are not waived under strict compliance standards are qualitatively different from those that are waived. Data on the delay caused by discrepancies and whether that delay could have been avoided if a substantial compliance standard had been applied, could possibly shed light on whether strict compliance helps or hinders the promptness, efficiency, and certainty of the letter of credit mechanism.

121. Banks actually have two kinds of discretion. First, they have discretion to determine if the documents strictly comply. Second, they have the discretion, if documents do not strictly comply, to waive or not waive the discrepancies. Banks take the position, supported in Official Comment 7 to U.C.C. section 5-108, that even if their customer, the applicant, waives the discrepancies, they have the right to decide independently whether or not they will waive the discrepancies. “Except as otherwise agreed with the applicant, an issuer may dishonor a noncomplying presentation despite an applicant’s waiver.” U.C.C. § 5-108 cmt. 7 (1995).

122. *See* U.C.C. § 1-203 (1990) (“Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.”) (bracket portion in original). Two clear duties of issuers are to “observe [the] standard practice of financial institutions that regularly issue letters of credit” and to “honor a presentation that . . . strictly . . . compl[ies] with the terms and conditions of the letter of credit.” U.C.C. § 5-108(e), (a) (1995).

123. *See supra* notes 80-83 and accompanying text.

As noted earlier, honesty in fact is generally determined by an inquiry as to the state of mind of the actor.¹²⁴ This subjective, good faith standard has traditionally applied in situations such as the purchase of negotiable instruments or the transfer of title to goods, with the purpose of facilitating the circulation of commercial paper and goods.¹²⁵ Good faith performance, on the other hand, is measured against an objective standard tied to commercial reasonableness.¹²⁶ In applying the subjective, honesty in fact test, courts have determined that if a person acted honestly, without an improper motive (pure heart), then the fact that his action was negligent or demonstrably foolish (empty head), would not indicate bad faith.¹²⁷

Yet, the test cannot be entirely subjective because the question of establishing good faith will depend on the credibility of the party claiming it, and a judge or jury will evaluate that credibility by an objective standard of reasonableness.¹²⁸ As noted by one court, “[T]he standard necessitates an intensive, detailed inquiry into the facts surrounding a transaction in order to determine just how ‘white’ the heart, how ‘empty’ the head.”¹²⁹ When courts examine the particular circumstances to determine if the party is making a credible claim of honesty in fact and measure that claim in accordance with objective standards, the differences between the objective and the subjective standards diminish substantially. Some commentators take the position that there is no longer a significant difference in the standards. Professor Van Alstine, for example, asserts that:

[A] subjective standard will involve a consideration of the surrounding circumstances to examine the candor of a party claiming “honesty in fact.” Thus, the precise content of even this minimalist duty of “good faith” will be decisively influenced by the facts and circumstances of the specific case, including the expectations that arise in the commercial and relational context.¹³⁰

124. E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 667-70 (1963).

125. *See id.* at 668. Good faith purchasers generally include holders in due course, purchasers in the ordinary course of business, and good faith purchasers for value. Whether a purchase was made in good faith should be determined by the purchaser’s state of mind, not necessarily by a reasonable person standard. *See id.* at 670.

126. *See id.* at 670. Professor Farnsworth notes that for a brief period, between 1824 and 1835, the objective test was applied to good faith purchase, but by the end of the nineteenth century, England and most American states had adopted a subjective test for good faith purchase. *Id.*

127. *Money Mart Check Cashing Ctr. v. Epicycle Corp.*, 667 P.2d 1372, 1373-74 (Colo. 1983); *Riley v. First State Bank*, 469 S.W.2d 812, 816 (Tex. Civ. App. 1971).

128. *See* Farnsworth, *supra* note 124, at 672 (“Under a subjective test of good faith it is always open to the trier of the facts to evaluate the credibility of a claim of ‘honesty in fact,’ and in doing so to take account of the reasonableness or unreasonableness of the claim.”).

129. *Marsh Invest. Corp. v. Langford*, 554 F. Supp. 800, 805 (E.D. La. 1982).

130. *See* Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1249 (1999) (internal footnotes omitted). “Close examination reveals that this abstract debate [over difference in subjective and objective standards of good faith] is rapidly becoming more theoretical smoke than practical fire.” *Id.* at 1247.

The coming together of the two standards appears to mirror the movement in the U.C.C., as well as in statutory and common law, toward using the broader standard of good faith measured by standards of commercial reasonableness.¹³¹

C. U.S. Bankers' Objections to the U.C.C. Obligation of Good Faith

Despite a general trend of commercial law to embrace standards of commercial reasonableness and fair dealing, the banking interests prefer to have good faith applied in the narrowest possible way, if at all.¹³² This may explain why the term "good faith," when used in Article 5, is not only limited to honesty in fact, but also, outside of the definition found in section 5-102(7), is mentioned in only one subsection of Article 5, which deals with fraud.¹³³ The bankers assert that U.C.C. § 1-203, which imposes an obligation of good faith on every contract or duty within the U.C.C., should not apply to letters of credit.¹³⁴ This is because, according to the bankers, letters of credit are a mercantile specialty and not a contract.¹³⁵ If the bankers' view is correct, honesty in fact would only come into play in instances of fraud, and letters of credit would be exempted from the good faith obligation otherwise imposed by U.C.C. § 1-203. As such, good faith would essentially have no effect on a bank's conduct in denying payment under a letter of credit.

This view does not, however, appear to have any support in the Uniform Commercial Code. U.C.C. § 1-203 unequivocally "imposes an obligation of good faith in [the] performance or enforcement" of "[e]very contract or duty within this Act."¹³⁶ Even if a letter of credit arrangement is not the kind of contract governed by U.C.C. Article 2 or the common law, it appears to be a contract consistent with the definition in Article 1, and therefore, it is subject to the requirement of good faith imposed by Article 1. Article 1 defines a contract as "the total legal obligation that results from the parties' agreement as determined by [the Uniform Commercial Code] as supplemented by any other applicable laws."¹³⁷ This definition is certainly broad enough to

131. See *supra* notes 77-79 and accompanying text.

132. James G. Barnes, *Defining Good Faith Letter of Credit Practices*, 28 LOY. L.A. L. REV. 101 (1994). Since Mr. Barnes, as he acknowledges in his article, represented the banking trade group, the USCIB (now known as the International Financial Services Association), during the negotiation and drafting of Revised Article 5, the views expressed in his article will be referred to as the views of the banking industry. See *id.* at 103 n.9.

133. U.C.C. § 5-109(a) (1995).

134. The bankers expressed their concern as follows:

We worry, however, that general UCC principles, notably the UCC section 1-203 principle that every contract or duty within the UCC imposes an obligation of good faith in its performance or enforcement, will be applied to letter of credit undertakings as if they were contracts. We oppose adding "and observance of reasonable commercial standards of fair dealing" to the current "honesty in fact" definition of "good faith."

Barnes, *supra* note 132, at 103.

135. See *id.* at 101-04.

136. U.C.C. § 1-203 (1990).

137. *Id.* § 1-201(12).

include the letter of credit arrangement, which results in legal obligations between the beneficiary and the bank. "Agreement" which is also defined in Article 1, means "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act."¹³⁸ The bank clearly assumes binding obligations toward the beneficiary when it issues the letter of credit.¹³⁹ The beneficiary does not have obligations to the bank until the letter of credit is honored, but at that time, it does have warranty obligations to the issuer.¹⁴⁰ Such obligations represent the bargain in fact of the parties, and their agreement is a contract subject to the good faith obligation of U.C.C. § 1-203.¹⁴¹

Regardless of whether a letter of credit is a contract, however, section 1-203 imposes the good faith obligation not just on every contract, but on every *duty*.¹⁴² It is beyond cavil that an issuing bank undertakes certain duties to the beneficiary. Those duties are set forth in Article 5, particularly in section 5-108, which is entitled, "Issuer's Rights and Obligations."¹⁴³ The bank's duties include, *inter alia*, the duty to "honor . . . presentation[s] [which] appear[] on [their] face strictly to comply with the terms and conditions of the letter of credit";¹⁴⁴ the duty to "observe [the] standard practice of financial institutions that regularly issue letters of credit";¹⁴⁵ and the duty, after dishonor, to "return the documents or hold them at the disposal of . . . the presenter" and notify the presenter.¹⁴⁶ Section 1-203 requires the bank to perform these and other duties in good faith.¹⁴⁷

138. *Id.* § 1-201(3).

139. The drafters of Revised Article 5 provided that "a '[l]etter of credit' means a definite undertaking." U.C.C. § 5-102(10) (1995). The dictionary definition of "undertaking" is "[a] promise, pledge, or engagement." BLACK'S LAW DICTIONARY 1562 (8th ed. 2004). The bank's promise, accepted by performance when the beneficiary presents documents, creates a contract. For a discussion of "The Letter of Credit as an Option Contract," see Arthur Fama, Jr., Note, *Letters of Credit: The Role of Issuer Discretion in Deterring Documentary Compliance*, 53 FORDHAM L. REV. 1519, 1532-33 (1985).

140. U.C.C. § 5-110(a) (1995). "[T]he beneficiary warrants . . . to the issuer . . . that there is no fraud or forgery" in the documents or the transaction. *Id.* Although the beneficiary does not have an obligation to present documents, the letter of credit arrangement is like a unilateral contract, where an offer can be accepted by performance. The beneficiary can accept the bank's offer to pay by presenting complying documents.

141. It has been suggested that a letter of credit is not a contract because there is no consideration running between the beneficiary and the issuing bank. *See* Fama, *supra* note 139, at 1531-32 n.88. Contract law clarifies, however, that a third party may provide consideration. *See id.* In a letter-of-credit transaction, the applicant is a third party who supplies consideration in the form of fees and a promise to reimburse the bank for the bank's agreement to issue the letter of credit. *See id.* Moreover, section 105 of Revised Article 5 provides that "[c]onsideration is not required to issue . . . a letter of credit." U.C.C. § 5-105 (1995). The Official Comment acknowledges that an issuer normally is not going to issue the letter of credit without consideration, but it explains that the provision simply eliminates any need for a beneficiary to have to prove that consideration has been given. *See id.*

142. U.C.C. § 1-203 (1990).

143. U.C.C. § 5-108 (1995).

144. *Id.* § 5-108(a).

145. *Id.* § 5-108(e).

146. *Id.* § 5-108(h).

147. U.C.C. § 1-203 (1990). Although the obligation to perform duties in good faith is found in Article 1 rather than Article 5, the provisions of Article 1 apply to all articles of the U.C.C., including Article 5, unless specifically displaced by provisions within those articles. *Id.* § 1-201(a). Since nothing

In the drafting committee for revised Article 5, the bankers preferred the “honesty in fact” standard over the broader standard, which included fair dealing, because they wanted “strict compliance” to be applied without any concern about “fair dealing.”¹⁴⁸ According to the bankers, adding “fair dealing” to the good faith definition would “invi[t] courts to look into the underlying transaction,”¹⁴⁹ and thus, undermine certainty of payment.¹⁵⁰ Of course, if the situation were one where the bank wanted to deny payment to the beneficiary simply because the applicant was insolvent, a “fair dealing” standard would not undermine certainty of payment, but would enhance it. Moreover, even under an honesty in fact standard, if a bank acted in good faith when the applicant was insolvent, it would decide whether to pay under the letter of credit in the same way that it decided in other letter of credit transactions, rather than looking for a technicality that would allow it to shift to the beneficiary losses the letter of credit was intended to prevent.¹⁵¹

As will be discussed in the next section, jurisdictions outside of the United States have less difficulty applying contract principles to the letter of credit to prevent bad faith dishonor.

D. Good Faith under Civil Law

During the drafting process for Article 5, the bankers objected to the broader good faith standard of fair dealing, claiming that Europeans and other non-Americans were afraid of a “runaway” good faith doctrine.¹⁵² This claim does not appear to be well-founded. The majority of countries in Europe and elsewhere in the world have a civil law system, rather than a common law system such as ours.¹⁵³ In the civil law system, good faith plays a major role, far greater than in the common law system.¹⁵⁴ As Professor Farnsworth has noted, “To the civilian mind, good faith is a broad reaching concept that covers far more territory than the comparable provision of Uniform Commercial Code section 1-203, which requires good faith in the performance of contracts.”¹⁵⁵

In the Prefatory Note to revised Article 5, the drafters declared their purpose to be one of “harmonizing” law in the United States “with interna-

in Article 5 appears to displace U.C.C. section 1-203, this section governs the legal obligations and specific duties of the issuer under Article 5.

148. See Barnes, *supra* note 132, at 104 n.10 (quoting Memorandum from Carlyle C. Ring, Jr., Chair to NCCUSL 2 (May 25, 1994)).

149. See *id.*

150. *Id.*

151. See Kozolchyk, *supra* note 14, at 451 (“In the same situation just described [insolvent applicant], a bad faith banker would find all sorts of extravagant or hypertechnical reasons for not paying.”).

152. See White, *supra* note 82, at 85; see also *supra* text accompanying notes 82-83.

153. Justice Robert F. Futter & David C. Lundsgaard, *Judicial Review in the New Nations of Central and Eastern Europe: Some Thoughts from a Comparative Perspective*, 54 OHIO ST. L.J. 559, 562 (1993).

154. E. Allan Farnsworth, *A Common Lawyer’s View of His Civilian Colleagues*, 57 LA. L. REV. 227, 234-35 (1996).

155. *Id.*

tional rules and practices,”¹⁵⁶ stating that this harmony was “essential” in order “[t]o facilitate [the] usefulness and competitiveness”¹⁵⁷ of letters of credit, which are “a major instrument in international trade.”¹⁵⁸ Since other countries generally include the concept of fair dealing in their notion of good faith,¹⁵⁹ however, the drafters of revised Article 5 may have put the United States out of step with the majority of other nations by imposing the narrow honesty in fact standard on letters of credit.¹⁶⁰

Since the standard of good faith to be applied to a letter of credit transaction will be the standard of the country whose law governs the transaction,¹⁶¹ it is useful to consider how other countries’ courts deal with good faith as applied to letters of credit, particularly the concept of strict compliance. In Switzerland and Germany, for example, the courts recognize the “strict compliance standard,”¹⁶² but apply contract law concepts to ensure that documentary compliance decisions are acceptable under the good faith requirement.¹⁶³ In a Swiss case, the Swiss Supreme Court found against a bank which had refused to honor a presentation in which the discrepancy was a missing delivery receipt.¹⁶⁴ Because the bank had actual knowledge that the goods had in fact been delivered, the court found that good faith required the bank to honor the letter of credit.¹⁶⁵ Thus, for the Swiss court, the good faith doctrine overrode strict compliance, since the bank had actual knowledge that the seller had performed its obligations under the underlying contract.¹⁶⁶ Bankers would argue that it is a violation of the independence principle to consider any contract other than the letter of credit agreement in

156. U.C.C. art. 5, Prefatory Note (1995) (referring to section subtitled “Need for Uniformity”).

157. *Id.*

158. *Id.*

159. Other common law countries, particularly the U.K., are exceptions. Traditionally, they have refused to recognize an obligation of good faith. *See* Farnsworth, *supra* note 154, at 235. In another article, Professor Farnsworth noted that more recently the Australians, Canadians, and English have expressed some interest in the good faith doctrine. E. Allan Farnsworth, *Duties of Good Faith and Fair Dealing Under the UNIDROIT Principles, Relevant International Conventions, and National Laws*, 3 *TUL. J. INT’L & COMP. L.* 47, 51-54 (1995).

160. The bankers’ claim that Europeans and other non-Americans were concerned about a “runaway” good faith doctrine does not appear to be based on empirical (or other) research. Concern that the drafters of uniform laws seem to rely on their own “hunches,” rather than empirical data, has been expressed by a number of commentators. *See, e.g.,* White, *supra* note 82, at 213 (1995) (“[T]he debate over law is among lawyers, not scientists, and is almost completely devoid of reliable empirical data. At every drafting meeting advisers made empirical assertions about American practice, practice in Oklahoma, practice in Europe or Asia; not one of those assertions was ever empirically verified.”); Edward L. Rubin, *Thinking Like a Lawyer, Acting Like a Lobbyist: Some Notes on the Process of Revising U.C.C. Articles 3 and 4*, 26 *LOY. L.A. L. REV.* 743, 770-72 (1993) (Despite the fact that pertinent “information would have been relatively easy and inexpensive to acquire,” the drafting committee lacked interest in empirical research and instead engaged in speculation) (quotation found at 771).

161. *See supra* note 72.

162. *See* Paolo S. Grassi, *Letter of Credit Transactions: The Banks’ Position in Determining Documentary Compliance: A Comparative Evaluation Under U.S., Swiss, and German Law*, 7 *PACE INT’L L. REV.* 81, 119-20, 125 (1995).

163. *Id.* at 119-20, 125.

164. *Id.* at 125.

165. *See id.* at 125-27. Grassi notes that, “The credit device is not granted a special status, i.e. mercantile character does not supersede contract law” *Id.* at 126.

166. *Id.*

deciding whether or not to honor the obligation. As noted above, however, this argument only seems to raise its head when banks do not want to honor a letter of credit for reasons outside the letter of credit agreement in violation of the independence principle: that is, when the bank fears that if it honors the letter of credit, it will not be reimbursed by the buyer under the reimbursement agreement.

The German Supreme Court, while also generally supporting a strict compliance standard, has held that the standard could be disregarded “if it was quite obvious to each person judging the case, without resorting to expert knowledge of any kind, that discrepancy was insignificant and that no disadvantages for the customer could result.”¹⁶⁷ According to Paolo S. Grassi, an attorney licensed to practice in both New York and Switzerland, “[t]he [result] is that, although [the] courts of [both Germany and Switzerland] recognize the strict compliance principle, they avoid the inequities of its rigid application by invoking contract law.”¹⁶⁸

V. APPLICATION OF GOOD FAITH WHEN THE APPLICANT IS INSOLVENT

A. *Good Faith and the Opportunistic Bank*

In their sales literature and marketing programs, banks make the claim that the letter of credit is a very secure payment mechanism, and that other than paying cash, it “affords the seller the highest degree of protection from loss.”¹⁶⁹ The seller is assured that “a letter of credit eliminates for the seller the credit risk of the foreign importer and substitutes that of the foreign bank opening the letter of credit.”¹⁷⁰ The seller is also informed that if the letter of credit is confirmed by a U.S. bank, her risk of non-payment will be even lower because the U.S. bank will also be obligated to make payment.¹⁷¹ A bank’s literature may also assert that its obligation to pay depends upon seller’s compliance with the specifications of the letter of credit: “With a letter of credit issued by a prime domestic bank, the seller is able to

167. *Id.* at 125 n.158.

168. *Id.* at 125.

169. The CORESTATES BANKS, INTERNATIONAL TRADE PROCEDURES: AN INTRODUCTION TO DOING BUSINESS ABROAD 6 (1988) [hereinafter CORESTATES].

170. *Id.*; see also BANK OF MONTREAL/HARRIS BANK, INTERNATIONAL TRADE GUIDE 30 (1995) [hereinafter MONTREAL/HARRIS] (stating that one of the main advantages of a letter of credit is that “[t]he exporter is relieved of many credit factors that would otherwise have to be considered, because the exporter relies on the credit of a bank rather than on that of the importer”). ABN-AMRO Bank expresses a similar idea: “As long as the letter of credit calls for the documents the exporter intends to produce, the exporter can consider his risk to have shifted from the buyer to the buyer’s bank.” WALTER BUDDY BAKER, ABN-AMRO BANK, INTERNATIONAL TRADE & ADVISORY: A GUIDE TO DOCUMENTARY PAYMENTS & SHORT TERM TRADE FINANCE 33, available at, http://www.maxtrad.com/pdf/Trade_Services_Primer.pdf (last visited October 15, 2005). See also GLOBAL TRADE SERVICES, BANK OF AMERICA, GUIDE TO LETTERS OF CREDIT 3 (2000) [hereinafter GLOBAL TRADE] (“The issuing bank’s obligation to pay supersedes that of the buyer. In other words, once the bank issues a L/C it is obligated to the beneficiary notwithstanding the ability of the account party to reimburse the bank.”).

171. CORESTATES, *supra* note 169, at 6 (“A confirmed irrevocable letter of credit is one step more secure than an unconfirmed one.”).

rely upon the creditworthiness of the bank, rather than on the importer [buyer], and is assured of payment once the seller complies with the terms of the letter of credit.”¹⁷² These marketing pamphlets do not appear to explain, however, what causes letters of credit to fail. One would not be able to ascertain from reading the literature that if the buyer becomes insolvent, a waiver of minor discrepancies may not be permitted by the bank, resulting in the denial of payment to a performing seller. Thus, even experienced sellers may be surprised when their letter of credit is not paid, especially if they performed exactly as they had in previous transactions with the same bank and the same buyer, where they had been paid.¹⁷³ If, in the interim, the buyer’s solvency is questioned by the bank, what worked for seller before will no longer work. Banks can take advantage of the strict application of letter of credit law to deny payment to a performing seller for the sole reason that the buyer is insolvent.¹⁷⁴ Protection from this risk was, of course, exactly what the seller expected when she chose to require payment by letter of credit. The banks which engage in this conduct are not limited to small, inexperienced banking entities, as will be seen in the discussion below of one such case. After considering an example of opportunistic conduct, the Article will consider whether the honesty in fact standard of good faith can make a difference in trying to curb this kind of opportunism.

I. *Bombay Industries, Inc. v. The Bank of New York*

In this case, The Bank of New York refused to honor a draft under a letter of credit even though the buyer/applicant, Collection Clothing Corporation, had waived the discrepancies.¹⁷⁵ The underlying contract between Bombay Industries, Inc. and Collection Clothing was for the sale of shorts and shirts.¹⁷⁶ Bombay Industries had imported the shirts and shorts, and had picked up these and other goods at a New Jersey port, trucked them to its New York warehouse to separate the goods for different client orders, and then delivered the appropriate shorts and shirts to Collection Clothing. Col-

172. MONTREAL/HARRIS, *supra* note 170, at 29. See also CORESTATES, *supra* note 169, at 6 (“An irrevocable letter of credit, as the name implies, represents an irrevocable commitment on the part of the opening bank to pay or accept the exporter’s draft so long as the accompanying documents meet the exact specifications of the letter of credit.”).

173. See *Bombay III*, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997). See also *infra* note 203 and accompanying text.

174. See, e.g., *Bank of Seoul v. Norwest Bank Minn.*, 630 N.Y.S.2d 520, 522 (N.Y. App. Div. 1995) (explaining that, after the bank became aware of applicant’s imminent bankruptcy filing, the bank refused to waive discrepancies previously waived by applicant); *AMF Head Sports Wear, Inc. v. Ray Scott’s All-Am. Sports Club, Inc.*, 448 F. Supp. 222, 223-24 (D. Ariz. 1978) (stating that, although requested by the both beneficiary and the applicant, the bank refused to amend the letter of credit to permit the credit to conform to the documents because the bank had reason to believe that the applicant would be unable to reimburse it).

175. See *Bombay Indus., Inc. v. Bank of N.Y. (Bombay I)*, No. 103064/95, 9817, 1995 WL 808811, at *1 (N.Y. Sup. Ct. Aug. 14, 1995), *rev’d*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997). This author worked on the brief of Plaintiff-Respondent Bombay Industries in the Appellate Division of New York Supreme Court.

176. *Id.*

lection accepted the goods with no complaints.¹⁷⁷ When Bombay presented documents under the letter of credit, the bank asserted two discrepancies.¹⁷⁸ First, according to the letter of credit, the bill of lading had to indicate that the goods were delivered from a New Jersey port, but the actual bill of lading showed goods delivered from New York.¹⁷⁹ Second, a statement submitted by Bombay to the effect that it had notified an individual of the shipping details by fax did not include the actual fax number.¹⁸⁰ Shortly after Bombay was notified by the bank of these two discrepancies, it learned that Collection Clothing had waived them.¹⁸¹ Bombay then tried to find out when it would be paid.¹⁸² The bank stated that an account officer would have to authorize payment, but it refused to identify which account officer.¹⁸³ For about two weeks, Bombay was unable to find out why payment was being delayed, despite repeated requests to the bank.¹⁸⁴ Finally, it learned from Collection Clothing what was really going on. Collection was indebted to the bank for \$6.8 million, and Collection and the bank were in the process of attempting to renegotiate a repayment of Collection's debt.¹⁸⁵ The bank was apparently awaiting the outcome of these negotiations before deciding whether to pay under the letter of credit. Ultimately, the negotiations broke down and the bank refused to honor the letter of credit.¹⁸⁶ The bank then caused Collection to go into bankruptcy and, as a secured creditor of Collection, took possession of the goods Bombay had shipped to Collection, liquidated the goods, and kept the proceeds in payment of other unrelated debts of Collection to the bank.¹⁸⁷

This is not the way a letter of credit is supposed to work. The discrepancies in question were waived by the buyer and did not demonstrate default by the seller in the underlying contract. The bank knew that its customer, the buyer, had accepted the goods and waived the discrepancies. The sole question at issue was who would bear the loss caused by the buyer's insolvency, the bank, or the letter of credit beneficiary? By calling upon the rules of strict compliance, the bank intended to shift back to the seller the loss caused by the buyer's insolvency. Thus, a major purpose of the letter of credit—shifting the risk of buyer's insolvency from the seller to the

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.*

183. See Affidavit of Chandresh Metha, President of Bombay Industries, Record on Appeal at 31-33, *Bombay I*, 1995 WL 808811 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997) [hereinafter *Metha Affidavit*] (record on file with author).

184. See *id.*

185. See *Bombay I*, 1995 WL 808811, at *1; *Mehta Affidavit*, *supra* note 183, at 32.

186. See *Bombay I*, 1995 WL 808811, at *1.

187. *Id.*

bank¹⁸⁸—was thwarted by the bank's self-interest in applying the strict compliance rules to deny payment.

Bombay brought suit against the bank for wrongful dishonor.¹⁸⁹ In granting Bombay's motion for summary judgment against the bank, the court found that although as a general rule, an issuing bank has the right to demand strict compliance with the requirements of a letter of credit, in this case, the bank based its decision not to waive the discrepancies "on factors outside the operative documents and contractual arrangements."¹⁹⁰ The court also found that the bank breached an implied covenant of good faith by causing Bombay not to be paid for goods delivered, enabling the bank to apply the value of those goods toward its secured debt.¹⁹¹ In addition, the court found that the bank acted in bad faith because it had previously waived discrepancies involving the same parties and the same discrepancy.¹⁹² The court did not decide the motion based on bad faith, however.¹⁹³ Rather, it found that irrespective of a finding of bad faith, the issuer wrongfully dishonored the letter of credit for the following reasons:

(1) [T]he issuer is a non-neutral party, (2) who consulted with, and sought a waiver from, the account party (3) but rejected the documents although the account party waived the discrepancies, (4) and the issuer gave no justification for not accepting that waiver, (5) although there is a pattern between the parties to waive discrepancies, and (6) the issuer shortly thereafter, as secured creditor, forced the liquidation of the account party.¹⁹⁴

The court concluded by finding that "[a]s [a] matter of policy, where a seller delivers goods to a buyer in reliance upon payment by a letter of credit, that seller must be able to know that the issuer will act in a neutral manner."¹⁹⁵

On appeal, the bank argued, *inter alia*, that an applicant's waiver of discrepancies does not *require* the issuer to honor discrepant draw documents,¹⁹⁶ and that since the bank had done nothing to prevent Bombay from

188. See *Alaska Textiles Co. v. Chase Manhattan Bank*, 982 F.2d 813, 815 (2d Cir. 1992) (noting that a letter of credit "permits the buyer in a transaction to substitute the financial integrity of a stable credit source (usually a bank) for his own").

189. See *Bombay I*, 1995 WL 808811, at *1.

190. *Id.* at *3.

191. See *id.*

192. See *id.*

193. See *id.* The court may well have asserted that the decision was not based on bad faith because it was decided as a summary judgment motion, and the question of good faith generally raises factual questions for the jury. The court also stated that the bank had not addressed the issue of whether it acted in bad faith.

194. *Id.*

195. *Id.*

196. See Reply Brief of Defendant-Appellant at 2, *Bombay I*, 1995 WL 808811 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997) (brief on file with author).

presenting conforming documents, the issues of good faith raised by the lower court were simply irrelevant.¹⁹⁷ The appellate court, with one strong dissent, reversed the grant of summary judgment to Bombay.¹⁹⁸ The majority did not mention the good faith issue, but only considered the legal impact of Collection Clothing's waiver of discrepancies.¹⁹⁹ It found summary judgment inappropriate because Collection's waiver of discrepancies "did not necessarily alter [the bank's] separate right to require strict compliance with the letter of credit."²⁰⁰ The dissent criticized "[t]he majority's cryptic analysis" as avoiding "the telling aspect of the situation."²⁰¹ According to the dissenting judge,

The implication is that the bank had a problem with the purchaser's general debt to the bank and was using this situation as leverage. Whether or not that is so, this plaintiff is an innocent party who made delivery acceptable to its purchaser. The bank should not be permitted to substitute its own agenda.²⁰²

After the grant of summary judgment had been reversed, a bench trial was held in the court below, and the lower court again found in favor of Bombay,²⁰³ but this time on the grounds that the bank failed to give Bombay timely notice that it was rejecting the documents within the seven-day limit required by the UCP.²⁰⁴ The bank had claimed that its notice of discrepancies constituted notice of dishonor.²⁰⁵ Fortunately for Bombay, however, the bank had recorded all telephone conversations between representatives of Bombay and the bank's employees, and these were turned over during discovery.²⁰⁶ Citing these conversations, as well as testimony of witnesses at trial concerning these conversations, the court found that bank employees continued long beyond the seven-day limit to give Bombay the impression that the discrepant documents might eventually be approved.²⁰⁷ Thus, the requirement that notice of rejection of the documents be given no later than seven days after presentation was not met, precluding the bank from dishonoring the letter of credit.²⁰⁸

Although the court made clear that the decision in Bombay's favor turned on the untimely notification of dishonor by the bank, it again stated

197. See *id.*

198. *Bombay Indus., Inc. v. Bank of N.Y. (Bombay II)*, 649 N.Y.S.2d 784, 784 (N.Y. App. Div. 1996), *remanded to No. 103064/95*, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997).

199. See *id.*

200. See *id.* (emphasis added).

201. *Id.* at 147 (Kupferman, J., dissenting).

202. *Id.* at 785.

203. See *Bombay III*, 1997 WL 860671, at *1.

204. *Id.* at *3; see also UCP 500, *supra* note 68, art. 14(d).

205. *Bombay III*, 1997 WL 860671, at *1.

206. See *id.* at *2-*3.

207. *Id.* at *3.

208. *Id.*

that the bank had acted in bad faith.²⁰⁹ In this second decision by the lower court, however, its view of the bank's bad faith was much more restricted. It found that the bank breached its duty of good faith by "conceal[ing] its intention to dishonor the letter of credit from Bombay."²¹⁰ The court no longer referred to the bank's breach of its obligation to be a neutral paymaster or its failure to waive discrepancies even though buyer/account party had waived them, and the bank had waived the same discrepancy in previous transactions with seller. Rather, having found an unimpeachable legal basis for its decision in the lack of timely notice, the court shied away from relying upon a breach of good faith.²¹¹ Nevertheless, the court observed in the final paragraph of its decision:

Although decided on purely legal grounds, the verdict produces an equitable result. BNY's [Bank of New York] refusal to honor the presentation documents caused Bombay to deliver goods to the account party without being paid for those goods. [T]his, in turn, enabled BNY to apply the value of those unpaid goods towards its secured debt because BNY was the account party's secured creditor and it caused the account party's liquidation.²¹²

Thus, the court believed it had reached a fair and equitable result, using solid legal grounds under letter of credit law. But this raises the question of how this court or another court might have decided this case if the issue of timely notification had not provided a convenient legal hook to reach a just result. Does the good faith standard of Article 5 provide a sufficient basis for finding liability against a bank which conducted itself the way the Bank of New York did in *Bombay*?

2. *The Reach of the "Honesty in Fact" Good Faith Standard*

The bank's position in *Bombay* was that no obligation of the bank arose until complying documents were presented by the beneficiary.²¹³ In the bank's view, if the beneficiary did not present complying documents, the question of good faith was irrelevant, since the bank, at that point, had no obligation to the beneficiary.²¹⁴ If that position is correct, then the honesty in fact standard of good faith, at least with respect to documentary presentations, is almost irrelevant. In cases where complying documents were presented, if the issuing bank failed to honor drafts under the letter of credit, then supposedly the honesty in fact standard would apply. But there would

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.* at *4.

213. There is some precedent for this narrow view of the good faith obligation. *See, e.g.,* Macintosh, *supra* note 7, at 11-16.

214. *See Bombay III*, 1997 WL 860671, at *1-*2.

be little need to consider good faith at that point, since an issuer's failure to honor complying documents would, by itself, be a breach of its obligation, without regard to state of mind. The only time good faith might matter would be when the discrepancies alleged by the bank appeared to be examples of oppressive perfectionism,²¹⁵ that is, they were too insignificant to make a difference for any purpose.²¹⁶ Thus, if one accepts the bank's position in *Bombay II*,²¹⁷ then the good faith requirement would rarely matter with respect to an issuer's obligation to pay on conforming documents.

This view of honesty in fact does not seem consistent, however, with the U.C.C., or with case law interpreting the meaning of honesty in fact. In determining whether a party has met the standard of honesty in fact, courts, as noted earlier, use a broad lens.²¹⁸ They consider the context of a particular action—the facts and circumstances which can show whether the action was taken with a “pure heart and empty head,” or whether the party acted with an improper motive, thereby failing to carry out its duties and obligations in good faith.²¹⁹

Does a bank meet the honesty in fact standard when its primary motivation for denying payment under a letter of credit is its belief that it will not be reimbursed by the applicant, although it claims that its reason for dishonor is that there were discrepancies in the documents? The bank argued in *Bombay II* that until complying documents were presented, it had no duty to honor, so therefore, it could not have violated any duty of good faith.²²⁰ But Article 5 makes clear that a bank's duties under letter of credit law are more varied and begin at an earlier point in time than simply at the moment documents are presented. A bank's lack of fulfillment of its obligations at an earlier point can provide the context for determining whether it acts with honesty in fact, when it denies payment under a letter of credit after learning of the applicant's insolvency.

B. Duties of the Issuing Bank

Two of the issuer's obligations are particularly pertinent to the question of whether a bank is acting in good faith when it dishonors a letter of credit because the applicant is insolvent. Issuers are obligated to (a) “observe [the]

215. See *supra* notes 84-91 and accompanying text.

216. See *Tosco Corp. v. FDIC*, 723 F.2d 1242 (6th Cir. 1983). In this case, the letter of credit referred to “Letter of Credit Number 105,” and the draft presented referred to “letter of Credit No. 105.” *Id.* at 1247. In addition to claiming that using “No.” rather than “Number” was a discrepancy, the bank also claimed that writing “letter” with a lower case “l” was a discrepancy. *Id.*

217. *Bombay II*, 649 N.Y.S.2d at 784.

218. See *supra* notes 124-31 and accompanying text.

219. See *supra* notes 124-31 and accompanying text.

220. See Reply Brief of Defendant-Appellant at 2, *Bombay I*, 1995 WL 808811 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to No. 103064/95*, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997) (brief on file with author).

standard practice of financial institutions that regularly issue letters of credit,²²¹ and (b) pay against complying documents.²²²

1. *Observing Standard Practices*

While many practices of institutions that regularly issue letters of credit are found in the UCP, the following also appear to be non-controversial standard practices of such institutions. First, banks carefully screen a letter of credit applicant—the buyer of goods in the underlying sales transaction—for creditworthiness, refusing to issue a letter of credit to anyone whose creditworthiness is in doubt;²²³ and second, banks serve as trusted paymasters in letter of credit transactions.²²⁴

a. *The Screening of a Letter of Credit Applicant*

Determining creditworthiness is something banks do on a regular basis.²²⁵ Their profit margins depend, in part, upon their ability to do this well. The evaluation of the creditworthiness of a buyer who is requesting a letter of credit is generally made in the same way a bank determines whether to make a loan.²²⁶ Bank of America describes the process as follows:

The bank looks at an import L/C line in much the same manner as any loan request. Careful evaluation is made of the customer's ability to reimburse Bank of America when drafts drawn under the L/C are presented or when time drafts (acceptances) mature. Furthermore, a review of the importer's [buyer's] overall credit strength is required when it is anticipated that loans will have to be made to finance the payment of the drafts. As with any type of commercial loan, the bank obtains appropriate borrowing authorization, resolutions, guarantees, etc., from the customer.²²⁷

The bank's incentive in a letter of credit case to screen the applicant carefully derives from the fact that, in some cases, the documents will be complying,²²⁸ and the bank will have to pay against such complying documents, even if the applicant is insolvent. As ABN-AMRO Bank explains in its booklet on documentary payments:

221. U.C.C. § 5-108(e) (1995).

222. *Id.* § 5-108(a).

223. *See Mann, supra* note 6, at 2526.

224. *See infra* notes 236-37 and accompanying text.

225. *See Mann, supra* note 6, at 2526 (“All of the bankers with whom I discussed the topic agreed, . . . that they engage in a serious screening process of customers for whom they issue letters of credit.”).

226. GLOBAL TRADE, *supra* note 170, at 8.

227. *Id.*

228. According to the studies, documents comply at least 10% of the time and possibly as much as 50% of the time. *See supra* note 29.

The issuance of a letter of credit constitutes a credit exposure on the part of the issuing bank to the importer [buyer] since the bank will have to pay regardless of the importer's financial ability at the time documents are presented. Therefore, the credit will be issued only if the credit standing of the importer is satisfactory to the issuing bank. Collateral may be required²²⁹

The standard practice is therefore to refuse to issue a letter of credit if the issuer believes the applicant is not creditworthy or suspects for any reason that reimbursement by the applicant will not be forthcoming. As Bank of Montreal/Harris Bank asserts, "The importer should understand that Bank of Montreal/Harris Bank is committing to pay a third party upon satisfactory performance under the letter of credit. As a result, the issuance of the credit is contingent upon the creditworthiness of the importer."²³⁰

Thus, careful screening of a letter of credit applicant and refusal to issue a letter of credit unless such applicant is creditworthy, is a non-controversial standard practice of financial institutions which regularly issue letters of credit.

b. The Trusted Paymaster and the Independence Requirement

The UCP, which governs virtually all letters of credit, contains rules that are considered under Article 5 to form a part of the "standard practice of financial institutions that regularly issue letters of credit."²³¹ UCP 14(b) requires a bank to determine *on the face of the documents alone* whether they comply with the terms of the letter of credit.²³² But UCP 14(c) permits the issuer to consult with its customer, the applicant, as to whether the applicant is willing to waive a discrepancy.²³³ The drafters of UCP 500 were concerned that written recognition of the common practice of the issuer consulting with the applicant might be seen as permission to override or ignore the independence principle.²³⁴ Charles del Busto, Chairman of the International Chamber of Commerce's Commission on Banking Technique and Practice, has explained that the purpose of UCP 14(c) is to address the

229. ABN-AMRO BANK, *supra* note 170, at 30. *See also* GLOBAL TRADE, *supra* note 170, at 3 ("The issuing bank's obligation to pay supersedes that of the buyer. In other words, once the bank issues a L/C it is obligated to the beneficiary notwithstanding the ability of the account party to reimburse the bank.")

230. MONTREAL/HARRIS, *supra* note 170, at 34 (quoting U.C.C. § 5-108(e)).

231. Official Comment 8 to section 5-108 states in pertinent part: "The standard practice referred to in subsection (e) includes (i) international practice set forth in or referenced by the Uniform Customs and Practice" U.C.C. § 5-108 cmt. 8 (1995). Subsection (e) requires an issuer to "observe standard practice of financial institutions that regularly issue letters of credit." *Id.* § 5-108(e).

232. UCP 500, *supra* note 68, art. 14(b).

233. *Id.* at art. 14(c).

234. *See supra* notes 104-109 and accompanying text. The independence principle holds that the issuer's obligations to the beneficiary under the letter of credit are independent of both (1) the underlying sales agreement between the buyer/applicant and the seller/beneficiary and (2) the agreement between the issuer and the applicant. *Alaska Textiles Co. v. Chase Manhattan Bank*, 982 F.2d 813, 815 (2d Cir. 1992); U.C.C. § 5-103(d) (1995); UCP 500 *supra* note 68, arts. 3, 4.

problem of “how to reconcile the independence of the bank’s obligation to the Beneficiary with the universal banking practice of the Issuing Bank contacting the Applicant for a waiver of the discrep(anc)ies.”²³⁵ According to Del Busto, “This reconciliation assumes that an approach by the Issuing Bank to the Applicant is justified only when the Issuing Bank acts *as an independent and trusted paymaster* and not as a conduit of the Applicant to refuse payment.”²³⁶ If the issuer must act as an independent and trusted paymaster, *vis-à-vis* the applicant, in order to comply with the independence principle, it is even more crucial that it act as an independent and trusted paymaster when its own interests are in conflict with those of the applicant or beneficiary.²³⁷ Perhaps more important, in order to act as an independent and trusted paymaster, the issuer should ensure that it does not put itself into a position where its interests will be in conflict with the applicant or beneficiary. The independence principle, as expressed in Article 5 and the UCP,²³⁸ requires the issuer to determine compliance *not* on the basis of its own self-interest but “*on the basis of the documents alone.*”²³⁹ When the motivation of an issuing bank not to pay under a letter of credit is its belief that it will not be reimbursed by the applicant, it is not making its decision on the basis of the documents alone. Therefore, it is in violation of the independence principle and the obligation to observe the standard practices of banks that regularly issue letters of credit. As Professor Boris Kozolchik has noted, in his writings on best practices:

The model banker invariably lives up to the UCP’s [p]rinciples of independence, neutrality, integrity and care in the performance of his duties as a paymaster. This banker observes the spirit as well as the letter of his promises, requests or orders of payment, even if his applicant or principal are unable or unwilling to reimburse him. . . . The model banker is willing to pay for the consequences of his mistakes²⁴⁰

235. CHARLES DEL BUSTO, DOCUMENTARY CREDITS UCP 500 & 400 COMPARED: AN ARTICLE-BY-ARTICLE DETAILED ANALYSIS OF THE NEW UCP 500 COMPARED WITH THE UCP 400 at 46 (1993).

236. *Id.* (emphasis added). Mr. Del Busto also noted, “Sharp, dishonest or negligent practices are invariably short-lived and do not constitute good international standard banking practice. International standard banking custom and practice for Documentary Credits contains the rules that embody honest and predictable practices.” *Id.* at 39.

237. See Kozolchik, *supra* note 3, at 61. “[T]he banks’ mission is to act as trusted and skilled paymasters, not as finders of reasons for non-payment.” *Id.*

238. See U.C.C. § 5-103(d) (1995); UCP 500, *supra* note 68, art. 3(a)-(b).

239. UCP 500, *supra* note 68, art. 14(b) (emphasis added).

240. See Boris Kozolchik, *The UNIDROIT Principles as a Model for the Unification of the Best Contractual Practices in the Americas*, 46 AM. J. COMP. L. 151, 164 (1998). Professor Kozolchik also notes that the UCP contains not only model practices, but also some self-interested practices, particularly those practices that limit or exempt the bank from liability. *Id.* at 165. For example, Article 16 disclaims liability for transmission of messages. *Id.* at 165 n.26. Even the self-interested banker, however, must, according to Professor Kozolchik, “act[] within the bounds of honesty. . . . He examines beneficiary’s documents punctiliously but does not reject the documents to avoid his loss of reimbursement.” *Id.* at 165.

2. *Paying Against Complying Documents*

a. *Meeting Reasonable Expectations*

In addition to the duty to observe the standard practice of financial institutions that regularly issue letters of credit, an issuing bank also has a duty to pay against complying documents.²⁴¹ The seller's expectations are that the letter of credit is a secure, prompt, and efficient payment mechanism, and that if the seller performs according to the terms of the underlying contract, the letter of credit will be honored. This expectation is created and fostered both by the banks' advertisement of their letter of credit product as a secure payment mechanism, and by actual commercial practices and experiences, since most letters of credit are eventually paid even though the documents contain discrepancies. According to the commentary on good faith by the U.C.C.'s Permanent Editorial Board (PEB), the reasonable expectations of the seller should be protected by the honesty in fact standard of good faith.²⁴² The PEB Commentary emphasizes that "[t]he agreement of the parties consists of more than their language alone."²⁴³ It further states that the concept of agreement found in Article 1 "permeates the entirety of the Code."²⁴⁴ Article 1 defines agreement as "the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade as provided in Section 1-303."²⁴⁵ Thus, an issuing bank's agreement to pay under a letter of credit is more than simply what is found on the face of the letter of credit because the agreement also includes the commercial context in which letters of credit exist. If the bank does not pay under the letter of credit, the critical question to ask, consistent with the PEB Commentary, "is, '[h]as [the issuing bank] acted in good faith with respect to the performance or enforcement of some right or duty under the terms of the Agreement?'"²⁴⁶ Does a bank, then, act in good faith when it refuses to pay under a letter of credit in which there are minor discrepancies, if such discrepancies are normally waived by the buyer and the bank, and the real reason for the bank's refusal to pay is that its customer is insolvent? The PEB Commentary suggests such conduct may not be in good faith:

241. U.C.C. § 5-108 (1995).

242. Permanent Editorial Board for the Universal Commercial Code, PEB COMMENTARY NO. 10 § 1-203 (Final Draft Feb. 10, 1994) [hereinafter PEB COMMENTARY]. The Permanent Editorial Board for the Uniform Commercial Code acts under the authority of the ALI and the NCCUSL. It periodically issues commentaries to provide guidance in interpreting and resolving issues raised by the U.C.C. and the official comments. On the first page of Commentary No. 10, the PEB states that "[t]his Commentary applies with equal force to both standards of good faith." *Id.* at 1.

243. *Id.* at 2.

244. *Id.* at 5.

245. U.C.C. § 1-201(3) (1990).

246. PEB COMMENTARY, *supra* note 242, at 5.

It is therefore wrong to conclude that as long as the agreement allows a party to do something, it is under all terms and conditions permissible. Such a conclusion overlooks completely the distinction between merely performing or enforcing a right or duty under an agreement on the one hand and, on the other hand, doing so in a way that recognizes that the agreement should be interpreted in a manner consistent with the reasonable expectations of the parties in the light of the commercial conditions existing in the context under scrutiny.²⁴⁷

The seller's reasonable expectation is that the letter of credit provides protection against buyer insolvency. When the context under scrutiny is that the issuing bank's customer is insolvent, and the bank is refusing to pay under the letter of credit, despite evidence that it would have paid absent buyer insolvency, courts should scrutinize this context using the broad lens required by the honesty in fact standard of good faith. A court should determine whether the bank is making its decision not to pay independent of any concern about its reimbursement contract with the applicant. Thus, the court would not just consider whether documents strictly comply, but also whether there is pertinent evidence that the bank has undermined the reasonable expectations of the beneficiary by refusing to perform only because the buyer has turned out to be insolvent. If this is the case, then the good faith obligation should limit, if not override, the application of the strict compliance rule.

b. Exercising Discretion

While bankers like to assert that there is little discretion involved in deciding whether or not to honor a letter of credit,²⁴⁸ it can be seen in the *Bombay* case that the bank clearly exercised discretion. The bank wavered for a number of days trying to restructure its agreement with its client, Collection Clothing, before determining to dishonor the particular draft in question under the letter of credit.²⁴⁹ It had, however, paid a prior draft under the same letter of credit, where there were identical discrepancies.²⁵⁰

247. *Id.* As noted earlier, the PEB stated clearly that its Commentary No. 10 applies not only to the broader good faith standard of "reasonable commercial standards of fair dealing," but also to the narrow standard of "honesty in fact." *Id.* at 1.

248. See Dolan, *supra* note 96, at 395.

249. See *Bombay III*, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997); Metha Affidavit, *supra* note 183, at 32.

250. See *Bombay I*, 1995 WL 808811, at *3. No. 103064/95, 9817, 1995 WL 808811, at *1-*2 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997). See Affidavit of Rudolf Lewis, an employee of Bombay Industries, Record on Appeal at 94, *Bombay I*, 1995 WL 808811 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997) (record on file with author).

When a bank reviews a documentary presentation for discrepancies, there are two kinds of discretion it will exercise. First, it will determine whether or not the documents comply. Since a “mirror image” standard for documentary compliance is not acceptable, nor is “substantial compliance,” the bank’s document checker must use discretion to determine whether any discrepancies in the documents presented fall between these two standards (more than substantial compliance, but not oppressive perfectionism).²⁵¹ Second, once the determination is made that there are discrepancies, the bank has discretion to waive those discrepancies and pay under the letter of credit.²⁵²

A bank also exercises its discretion prior to a beneficiary’s presentation of documents, when it determines whether or not to issue a letter of credit on behalf of a particular applicant. It also exercises discretion in determining whether or not to put itself into a position where it has a serious conflict of interest with the beneficiary, rendering itself incapable of functioning as an independent and trusted paymaster.²⁵³

Where a party has discretion in its conduct toward the other party to an agreement, U.C.C. § 1-203 imposes a good faith restriction on the use of discretionary power.²⁵⁴ As one commentator has noted, “[A] good faith limitation on the exercise of discretionary powers inheres from the very inception of the contractual relationship. . . . The short of the matter is that the law begins with a presumption of good faith limitations on discretionary rights”²⁵⁵ In applying an “honesty in fact” standard to an issuer’s dishonor of a letter of credit, the court should determine whether the bank, in each instance where it had discretion, exercised that discretion honestly, without an improper motive, and in a manner that would meet the reasonable expectations of the beneficiary.

C. *The Issuing Bank’s Failure to Act with Honesty in Fact*

It should be noted that most banks carry out the duties discussed above without fault. Banks screen the letter of credit applicant carefully to make sure he is creditworthy and do not issue a letter of credit unless there is sufficient collateral or other means of assuring that the bank will be reimbursed if it pays the seller under the letter of credit. They function as trusted paymasters, and they refuse to work with customers who they believe are not

251. See generally Fama, *supra* note 139.

252. See Dolan, *supra* note 96, at 383-84, 399.

253. An example of a bank not acting as an independent and trusted paymaster can be found in *Lectrodryer v. SeoulBank*, 91 Cal. Rptr. 2d 881, 882 (Cal. Ct. App. 2000). SeoulBank sought and received from the applicant cashier’s checks in the amount payable under the letter of credit it had issued for the benefit of Lectrodryer. *Id.* After applicant waived discrepancies, SeoulBank nonetheless denied payment to the beneficiary and used the funds provided by applicant to reduce SeoulBank’s exposure on applicant’s credit line with the bank. *Id.* The beneficiary, Lectrodryer, sued the issuer on an unjust enrichment theory, and the California Court of Appeals affirmed a jury verdict in Lectrodryer’s favor. *Id.* at 884.

254. U.C.C. § 1-203 (1990).

255. Van Alstine, *supra* note 130, at 1289.

acting honorably and in good faith.²⁵⁶ They meet the reasonable expectations of the seller/beneficiary that the letter of credit will be paid even though the documents contain some discrepancies.²⁵⁷ Thus, they set a standard of conduct that other banks are obligated to follow. This standard practice permits letters of credit to be honored most of the time.²⁵⁸

When letters of credit fail absolutely, despite performance of the underlying contract by the seller, the reason can frequently be traced to prior failure of the issuing bank to perform a duty. Having failed in one or more of its duties, the bank denies payment not because of discrepancies in the documents, but because its earlier lapses in judgment or failure to observe standard practice would cause an adverse impact on the bank if payment was made.²⁵⁹ As a result, the bank does not meet the reasonable expectation of the performing seller, who thought the letter of credit was a secure payment mechanism. When the bank denies payment in such circumstances, it is *not* doing so in good faith based on non-complying documents. When it claims that it is doing so, it is dishonest.²⁶⁰ Its real motivation comes from its fear of losing money, as a result of its prior failure to follow the standard practices of financial institutions that regularly issue letters of credit.

One could argue that the failure to screen applicants for creditworthiness is not necessarily itself an act of bad faith—it could be negligence. On the other hand, it could be an act of bad faith if, for example, the bank acted for dishonest reasons in exercising its discretion to accept the applicant's letter of credit request. Whether deemed an act of negligence or bad faith, however, failure to screen for creditworthiness is a breach of the bank's duty to follow the standard practice of financial institutions that regularly issue letters of credit. In breaching this duty, the bank would not meet the expectations of the beneficiary, assuming one accepts Professor Mann's

256. See Mann, *supra* note 6, at 2526-28 (discussing banks' concerns about probity and character of applicants and banks' refusal to issue letters of credit to applicants who want to have "built-in discrepancies" that will prevent a beneficiary from obtaining payment).

257. See *id.* at 2525. Several bankers, especially in Japan, "reported that they 'persuade[d]' or 'pressure[d]' their customers to waive the discrepancies in any case in which the seller's performance was not seriously defective." *Id.* (alteration and emphasis in original).

258. Estimates are that letters of credit fail completely only about 1% of the time. See Byrne, *Reactions to Minor Discrepancies*, *supra* note 5.

259. In *AMF Head Sports Wear, Inc. v. Ray Scott's All-Am. Sports Club, Inc.*, 448 F. Supp. 222, 223-24 (D. Ariz. 1978), the bank refused to agree to requests from both the applicant and the beneficiary to amend the letter of credit to conform it to the documents presented. Although the court found the bank had no duty to modify the letter of credit, it noted that "the bank [had] issued the letter of credit . . . without checking the financial status of [the applicant]." *Id.* at 223. It further noted that because the applicant appeared "unable to reimburse the bank" if the letter of credit was honored, the bank, by refusing to modify the letter of credit, "was able to extricate itself from a precarious financial position." *Id.* Acknowledging that the conduct of the bank was inequitable, the court nonetheless refused to find it acted in bad faith. See *id.* at 225.

260. Professor Macintosh notes that when the issuer dishonors upon learning that its customer is insolvent, "its dishonor cannot be characterized as a good-faith effort to satisfy its statutory obligation to examine documents carefully for facial compliance with credit terms. Rather, the dishonor is pretextual, because the issuer acts *solely* for the ulterior motive of avoiding financial loss." Macintosh, *supra* note 7, at 11 (emphasis in original).

thesis that the letter of credit functions in large part as a verification of the creditworthiness of the applicant.²⁶¹

The bad faith conduct that is the focus of this Article occurs when the bank denies payment because its applicant is insolvent, while claiming that the reason is non-complying documents. In determining whether non-compliance of the documents is the actual reason for denial, or a dishonest, pretextual reason, a court should consider facts and circumstance that shed light on whether the bank, at all stages of the letter of credit process, followed the practice of institutions that regularly issue letters of credit. This illuminates the credibility of the bank as to how pure the heart, and how empty the head.

In the *Bombay* case, for example, the bank issued a letter of credit to the applicant, Collection Clothing, even though Collection Clothing was indebted to the Bank for more than \$6.8 million and its financial situation was not strong.²⁶² In deciding, nonetheless, to issue a letter of credit, the bank left itself open to questions as to whether it followed the standard practice of banks which regularly issue letters of credit, such as insisting upon the creditworthiness of a customer as a condition of issuing a letter of credit. When the bank refused payment to Bombay under the letter of credit, forced Collection Clothing into bankruptcy, liquidated Collection Clothing's assets (including goods Bombay had delivered subject to the letter of credit), sold those goods, and kept the proceeds, the bank did not appear to be acting as a trusted paymaster but rather in its own direct self-interest.²⁶³ This could be considered a breach of its obligation to follow the standard practice of banks that regularly issue letters of credit, which is to conduct themselves as independent and trusted paymasters. Finally, the denial of payment to Bombay allegedly for minor discrepancies which had been waived by the applicant and were identical to discrepancies in a prior shipment under the same letter of credit that the bank had already paid, suggests a failure to exercise discretion in good faith to pay under the letter of credit.²⁶⁴

While it appears true that the documents in the *Bombay* case did not "strictly comply," if the honesty in fact good faith standard means anything at all, a court cannot consider the strict compliance standard in isolation from other obligations imposed by law on a bank. Rather, using a broad lens, it must consider whether the bank exercised, in good faith, its discretion to pay under a letter of credit. Was the decision to deny payment honest in fact? The evidence discussed above suggests that the bank's decision to dishonor was *not* based on the receipt of non-complying documents, but rather on its desire to avoid losses. The decision was, therefore, not "honest in fact" because it was not based solely on the documents. Thus, the bank's

261. See Mann, *supra* note 6, at 2521.

262. See *Bombay I*, 1995 WL 808811, at *1 (N.Y. Sup. Ct. Aug. 14, 1995), *rev'd*, 649 N.Y.S.2d 784 (N.Y.A.D. Nov 12, 1996), *remanded to* No. 103064/95, 1997 WL 860671 (N.Y. Sup. Ct. May 21, 1997).

263. See *id.*

264. See *id.*

conduct would fail to meet the honesty in fact standard because the real reason for the denial was the bank's knowledge that it would not be reimbursed by its insolvent customer. Had Collection Clothing been creditworthy, the bank would have honored the letter of credit.

Thus, in addition to the ground of untimely refusal of documents,²⁶⁵ a second ground was available to the court to decide in favor of Bombay. The court could have found that the bank breached its obligation to pay in good faith because its decision to deny payment was not in fact based on documentary non-compliance but motivated by the bank's desire not to pay out money which could not be reimbursed by the insolvent applicant. The bank not only shifted the loss of payment to Bombay, but also took Bombay's delivered goods, sold them, and kept the money. This conduct should not be found to meet the "honesty in fact" standard.

In applying the honesty in fact standard of good faith to a bank's denial of payment under a letter of credit when the applicant is insolvent, a court should, in order to determine whether a bank is acting with a pure heart and an empty head, consider the context of the letter of credit transaction to determine the bank's true motivation.²⁶⁶ The applicant's insolvency should create a prima facie case that denial of payment under the letter of credit, although allegedly based on discrepancies, is in fact based on the bank's concern that it will not be reimbursed by the applicant, and thus, is dishonest and in violation of the good faith standard. This prima facie case should be rebuttable by the bank, if it can show that, in the context of this particular letter of credit transaction, the bank observed the standard practice of banks that regularly issue letters of credit. This might be done in a variety of ways. The bank might show, for example, that it carefully screened the applicant, and that it had no knowledge and no reason to know that the applicant was in financial trouble either at the time it issued the letter of credit or at the time it made its decision not to pay. It might show that it acted at all times

265. See *supra* notes 203-208 and accompanying text.

266. The examples provided in *Bombay I*, 1995 WL 808811 at *1, and *Courtaulds North America, Inc. v. North Carolina National Bank*, 528 F.2d 802, 803 (4th Cir. 1975), involve issuing banks but no confirming banks, so the beneficiary is dealing directly with the issuing bank. Applying the good faith standard with a confirming bank present is more complicated. Letters of credit are generally confirmed in international transactions if the seller has some concern about either the solvency of the foreign bank or the political stability of the country where it is located. A confirming bank is usually in the beneficiary's country and adds its confirmation to the obligation of the issuing bank. This means the confirming bank assumes the same obligation as the issuing bank to pay if documents comply. Thus, in the event of wrongful dishonor, the beneficiary has the right to sue either the confirming bank or the issuing bank. When there are discrepancies in a presentation to the confirming bank, it will generally inquire of the issuing bank, who will inquire of its customer whether the customer is willing to waive the discrepancies. Since the confirming bank generally has no direct contact with the customer and was not involved in screening the customer's creditworthiness, it is unlikely that a confirming bank would be found to have acted in bad faith when denial of payment is made after the applicant has become insolvent. The beneficiary would have to sue the issuing bank, and generally, the law of the issuing bank's jurisdiction applies. Thus, a U.S. beneficiary of a letter of credit issued by a foreign bank would sue in the foreign country, where the foreign jurisdiction's law on good faith would apply. A foreign beneficiary of a letter of credit issued by a U.S. bank could sue the issuing bank in the U.S. under Article 5 of the U.C.C. See U.C.C. § 5-116(b) (1995) ("Unless [otherwise determined by the parties], the liability of an issuer . . . is governed by the law of the jurisdiction in which the person is located.").

as an independent and trustworthy paymaster and exercised its discretion in good faith, without any improper motive. It might also show that the particular discrepancy in the documentary presentation was so egregious that it appeared that the seller had not properly performed.

If, however, the bank cannot overcome the prima facie case of bad faith created upon its denial of payment to the beneficiary when the applicant is insolvent, then the trier of fact should find that the decision to deny payment was a wrongful dishonor on the ground that the bank did not act with honesty in fact.

Although banks would undoubtedly object to these requirements as burdensome, it must be remembered that the burden would only occur when the applicant is insolvent. Since most banks do a good job of not issuing letters of credit to uncreditworthy applicants, the burden would, for the most part, fall where it is most deserved—on banks that have not followed the standard practice of financial institutions that regularly issue letters of credit.

When the applicant has waived the discrepancies, and the issuing bank has nonetheless refused to honor the letter of credit, there arises a clear question of whether the issuer has met the honesty in fact good faith standard. Should the application of the honesty in fact standard be any different if the applicant does not waive the discrepancies, but its failure to waive is attributable to the applicant's insolvency? In *Courtaulds North America, Inc. v. North Carolina National Bank*,²⁶⁷ the “[b]ank refused to honor a draft” under a letter of credit, allegedly because of a discrepancy in the commercial invoice.²⁶⁸ The invoice was supposed to state “100% acrylic yarn,” but instead stated “Imported Acrylic Yarn.”²⁶⁹ Staped to the invoice, however, was a packing list which said “100% Acrylic.”²⁷⁰ Identical invoices submitted under the same letter of credit had previously resulted in payment after waiver by the applicant.²⁷¹ In response to previous documentary submissions under the same letter of credit, the bank had always paid Courtaulds, without ever informing Courtaulds that the bank considered the invoices discrepant.²⁷² Thus, until the bank dishonored, the beneficiary had no way of knowing that its prior submissions were considered non-complying. Because Courtaulds had received no notice of non-compliance regarding its prior presentations and received no complaints from the buyer about the quality of the goods, it was quite surprised when informed that its latest submission contained discrepancies that would not be waived.²⁷³ The decision not to waive the discrepancies was made because a bankruptcy

267. *Courtaulds*, 528 F.2d at 803.

268. *Id.*

269. *Id.*

270. *Id.*

271. *See id.* at 804.

272. *See id.*

273. *See id.*

trustee had been appointed for the applicant, and the applicant, alone, lacked the authority to waive the discrepancies.²⁷⁴

The Fourth Circuit reversed a lower court holding in favor of the beneficiary, applying the doctrine of strict compliance to relieve the bank of any liability.²⁷⁵ There was no discussion of good faith or of the obligation of the bank to observe the standard practice of financial institutions that regularly issue letters of credit.²⁷⁶ This is a classic case where a seller sought a letter of credit to protect itself from the buyer's insolvency, and the letter of credit worked fine—up until the buyer became insolvent. As a result of the buyer's insolvency, the letter of credit failed as a payment mechanism. The bank, however, appears to have breached its obligation to observe standard practice because it issued a letter of credit to an applicant who was not creditworthy.

In *Courtaulds*, there was sufficient evidence to take the case to the factfinder on the honesty in fact issue. The bank's decision to deny payment of the last draft submitted under the letter of credit was not based on the presence of discrepancies because the bank had paid under the same letter of credit over identical discrepancies.²⁷⁷ The reason for the bank's denial should rather be seen as a refusal to honor because it did not want to suffer losses when the insolvent applicant could not reimburse it. Thus, the stated reason—non-complying documents—would be dishonest and therefore in bad faith.

When the reason for refusing to waive discrepancies appears, as in *Courtaulds*, to be the buyer's insolvency, the buyer's failure to waive discrepancies should not be relevant to the court's analysis.²⁷⁸ When the buyer does not waive the discrepancies, the bank will no doubt protest that it will not be reimbursed if it pays over non-complying documents. But the bank may not be reimbursed in any event when the applicant is insolvent. Moreover, since the bank will generally have in its reimbursement agreement a provision that the applicant must reimburse the bank when documents *substantially* comply, rather than strictly comply, discrepancies such as the bank alleged in *Courtaulds* should not prevent the applicant from reimbursing the bank, assuming there was any ability to reimburse.²⁷⁹ Pertinent evidence of whether there was honesty in fact in a case like *Courtaulds* should be whether the bank breached its obligation to observe standard practice by issuing a letter of credit to a non-creditworthy applicant. Other evidence relevant to a finding of bad faith would be that the same or similar discrepancies did not block payment in previous drafts or letters of credit between

274. *See id.*

275. *See id.* at 805-07.

276. *See id.*

277. *Id.* at 804.

278. Before the appointment of the bankruptcy trustee, the applicant had waived the same discrepancy and never complained about any of the goods delivered, including the goods for which payment was denied. *Id.* at 804.

279. *See supra* notes 119-120 and accompanying text.

the same applicant and beneficiary. Once it is established that the bank breached its obligation to follow the standard practice of institutions which regularly issue letters of credit, the doctrine of strict compliance should be subordinated to a requirement that the bank must in good faith meet the reasonable expectation of the seller that the letter of credit will provide it with protection against the buyer's insolvency.

VI. CONCLUSION

This Article has made the argument that under a fair reading of U.C.C. Articles 1 and 5, the honesty in fact good faith standard should, in cases of applicant insolvency, prevent a bank from being able to deny payment under a letter of credit on the grounds of "strict compliance," when the real reason for the dishonor is the bank's fear of suffering losses. This incursion into the rigid nature of strict compliance is not a large one. Insolvency among applicants does not occur often, particularly when banks follow the standard practice of carefully screening applicants for creditworthiness. Moreover, policy considerations support making strict compliance less absolute when the applicant is insolvent. If courts or juries place liability on an issuing bank which denies payment to a performing seller when the applicant is insolvent, what will be the consequence? First, the bank will have an even stronger incentive than currently exists to screen applicants and only issue letters of credit on behalf of creditworthy applicants.²⁸⁰ Second, if a bank knows that whenever the applicant is insolvent, any denial of payment to the beneficiary will create a prima facie case that a violation of the duty of good faith has occurred, more letters of credit will be promptly paid. This will serve to enhance the letter of credit as a prompt, secure, and efficient payment mechanism—one which functions as the banks claim, by protecting the seller from the risk of the buyer's insolvency. No purpose appears to be served in permitting a bank to transfer to a performing seller the losses which the seller sought to protect itself against by using a letter of credit. Such conduct undermines the letter of credit as a secure payment device.

Bankers will argue that once you diminish the strict compliance obligation, then the letter of credit will lose its characteristics of swiftness and certainty that are made possible by focusing strictly on the compliance of documents. In the case of the opportunistic bank, however, it is already focused on something other than the documents—the financial status of the party from whom it will seek reimbursement. Its decision to deny payment is therefore not made on the documents alone, but rather on the basis of another contract, the reimbursement agreement, which according to the independence principle, should have no impact on the bank's obligations un-

280. Banks might argue that such a standard will make it more difficult for smaller and newer businesses to obtain a letter of credit. But the bank should already be including that risk into its calculation of whether to grant credit to an entity that may be financially weak, rather than assuming that any losses caused by applicant insolvency can be shifted back to the beneficiary.

der the letter of credit. The argument for heightened scrutiny of a bank's conduct when the bank's customer is insolvent is an argument for courts and juries to consider the letter of credit transaction with the broader lens required by honesty in fact. It is only by considering the bank's conduct in light of its obligations that a fact-finder can determine whether the bank acted with a proper or an improper motive. Courts should hold a bank to its obligation to issue a letter of credit only to a creditworthy customer. If a bank does not do so, or if it does not function as a trusted paymaster because it is serving its own direct self-interest, courts should find the bank has breached its obligation to observe the standard practice of financial institutions that regularly issue letters of credit. When a bank which denies payment under a letter of credit has an insolvent applicant, the bank's failure to follow the standard practices described above should provide evidence for determining whether it has acted in good faith. If it appears that absent applicant insolvency, the letter of credit would be honored, then the bank is acting dishonestly because the reason it asserts for denying payment to the beneficiary—non-conforming documents—is not the bank's real motivation. While it is conceivable that a bank could establish that despite applicant insolvency, the denial of payment was not in bad faith, the burden should be placed on the bank to rebut a *prima facie* case of bad faith.

Deterrence of a bank's opportunism in cases of applicant insolvency will make the letter of credit a more efficient, prompt, and secure payment mechanism. It will provide benefits not only to the immediately affected beneficiary, but to the reliability and proper functioning of the letter of credit system. In this way, it will also benefit those financial institutions that follow the standard practice, and that regularly, and properly, issue letters of credit.