CONFIRMING LETTERS OF CREDIT AFTER *NORTHERN TRUST:* A TRAP FOR THE INNOCENT

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Resumen

En el caso de Northern Trust Co. v. Community Bank, *el Tribunal Federal de Apelaciones para el noveno circuito sostuvo que un banco confirmante es responsable del pago al beneficiario de una carta de crédito que presente los documentos pertinentes al banco que emite la carta de crédito, aun cuando no haya habido presentación alguna al banco confirmante. La autora argumenta que* Northern Trust *conflije con la costumbre de la industria bancaria de requerir la presentación separada e independiente de documentos al banco confirmante. Además, la autora sostiene que de acuerdo a* Northern Trust, *un banco confirmante mantiene indefinidamente su responsabilidad frente al beneficiario sin contar con oportunidad alguna de revisar los documentos originales presentados. En conclusión, la autora ofrece recomendaciones a los bancos confirmantes a la luz de la decisión de* Northern Trust.

I. INTRODUCTION

The recent decision of the United States Court of Appeals for the Ninth Circuit in *Northern Trust Company v. Community Bank*,[1] may significantly alter the structure of letter of credit transactions. Letters of Credit (or "credits") have been issued by American banks for over 100 years. Their origins, however, date back at least to the Middle Ages, and evidence even suggests that the Romans used related instruments.[2] Letters of Credit developed, in part, because merchants who were unknown to one another or who were located in different geographical areas found it difficult to pursue trading relationships. A party of known solvency, such as a bank, could facilitate trading relationships by issuing its own promise to pay the seller

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1. 873 F.2d 227 (9th Cir. 1989).

2. For a discussion of the historical development of letters of credit, see Kozolchyk, *The Legal Nature of the Irrevocable Commercial Letter of Credit*, 14 AM. J. COMP. L. 395 (1965).

for the account of the buyer. Since these modest beginnings, letters of credit have evolved to play a major role in international trade, investments and financing.

II. LETTERS OF CREDIT

A letter of credit generally involves three separate parties and three independent contractual relationships: (1) the purchase-and-sale contract between the buyer (the applicant for the letter of credit, the "account party") and the seller (the beneficiary of the letter of credit, the "beneficiary"); (2) the agreement between the account party, who applies for the letter of credit, and its bank (the "issuer") with respect to the issuance of the credit; and (3) the letter of credit itself which represents an agreement on the part of the issuer to pay the beneficiary.[3]

Under traditional commercial letters of credit, the issuer promises to pay the beneficiary on demand when the beneficiary presents the documents specified by the credit.[4] The presented documents reflect the beneficiary's performance of his contract with the account party. Generally, the required documents include original bills of lading, invoices and other documents which give the holder of the credit the right to possess the subject goods. In recent years, the low cost of letters of credit and their adaptability have led to their use in a variety of business transactions beyond the traditional sale of goods, particularly in domestic markets.[5] Letters of credit have served as a form of security in lieu of performance bonds,[6] assured compliance with the conditions of loan commitments,[7] assured repayment of loans,[8] and supported both commercial paper and municipal debt obligations.[9] These

3. *See* Chase Manhattan Bank, N.A. v. Equibank, N.A., 550 F.2d 882, 885 (3d Cir. 1977); International Leather Distribs., Inc. v. Chase Manhattan Bank, N.A., 464 F. Supp. 1197, 1201 n. 9 (S.D.N.Y. 1979); Baker v. National Boulevard Bank of Chicago, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975); Dynamics Corp. of America v. Citizens & Southern Nat'l Bank, 356 F. Supp. 991, 995 (N.D. Ga. 1973).

4. *See* U.C.C. § 5-114 (1977); Asociacion de Azucareros de Guatemala v. United States Nat'l Bank, 423 F.2d 638, 641 (9th Cir. 1970).

5. Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank of San Francisco, 493 F.2d 1285, 1286 (9th Cir. 1974). For a general discussion of standby credits, see Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716 (1973); Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 320 (1982); Kozolchyk, *Is Present Letter of Credit Law up to its Task?*, 8 GEO. MASON L. REV. 285 (1988).

6. Victory Carriers, Inc. v. United States, 199 Ct. Cl. 410, 417, 467 F.2d 1334, 1340 (1972).

7. Fidelity Bank, N.A. v. Lutheran Mut. Life Ins. Co., 465 F.2d 211, 212 (10th Cir. 1972).

8. Lumbermans Acceptance Co. v. Security Pac. Nat'l Bank, 86 Cal. App. 3d 175, 150 Cal. Rptr. 69 (1978).

9. The use of standby credits to support publicly issued debt and equity securities raises the issue of whether the credits themselves constitute a separate security subject to registration under the securities laws. It is clear that although such letters of credit come within the definition of a security, they also are exempt from registration. Under Section 3(a)(2) of the Securities Act of 1933 (1933 Act), as amended, "any security ... issued or guaranteed by any bank" is exempt from

diverse types of letters of credit are collectively referred to as "standby" letters of credit because they stand behind, or guarantee, the account party's obligation to the beneficiary. Standby credits are issued for a variety of reasons. As with traditional commercial letters of credit, a lender may not accept the debtor's credit risk but may accept the unconditional obligation of a bank that stands behind the debtor.[10] In a commercial letter of credit transaction, when the beneficiary presents the documents required by the credit, he represents that the underlying contract has been performed. Upon presentation, the issuing bank obtains a security interest in the goods being sold. In contrast, under a standby letter of credit, the issuer agrees to pay the beneficiary upon presentment of documents evidencing the account party's default on a payment obligation to the beneficiary.

The beneficiary provides the bank with documents indicating the occurrence of a default or some other specified event as required by the letter of credit. Therefore, even though the bank receives documents under both commercial and standby letters of credit, standby credits create additional risks of nonpayment by the account party. In a standby letter of credit transaction, the issuer receives only a notice rather than collateral and the notice indicates a default or dispute with respect to the underlying transaction. This distinction has resulted in different regulatory and accounting

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the registration requirements of that Act. The Securities Act of 1933, 15 U.S.C. § 77c(a) (1988). The term "bank" is defined by section 3(a)(2) as "any national bank, or any banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." *Id.* Although a letter of credit does not constitute a "guarantee" for purposes of the banking laws, the Staff of the Securities and Exchange Commission (SEC) has consistently taken the position that (i) a letter of credit issued by a bank (as defined above) would be the functional equivalent of, and so would constitute, a "guarantee" by the bank for purposes of section 3(a)(2) of the 1933 Act and, thus, (ii) the debt instruments supported by that letter of credit and the bank's letter of credit itself would constitute securities "issued or guaranteed by any bank" for purposes of section 3(a)(2) of the 1933 Act. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77, 214 at 77,959 (Oct. 5, 1981) (letters of credit supporting non-redeemable mortgage pass-through type certificates).

Although foreign banks or their state branches or agencies are not literally within the term "bank" under section 3(a)(2) of the 1933 Act (because they are not "organized under the laws of any State"), the SEC Staff has taken the position that a state-licensed branch or agency of a foreign bank is the functional equivalent of a "bank" for the purposes of section 3(a)(2). *See e.g.*, Barclays Bank Int'l, Ltd., New York Agency, SEC No-Action Letter, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,080, at 77,721 (Oct. 30, 1981). The SEC formalized its position in an interpretive release effective September 23, 1986. Securities Issued or Guaranteed by the United States Branches or Agencies of Foreign Banks, Exchange Act Release No. 33-6661, 1 Fed. Sec. L. Rep. (CCH) ¶ 2024A (Sept. 29, 1986). Under that Release, the Commission deems a branch or agency of a foreign bank located in the United States to be a bank under Section 3(a)(2) if the nature and extent of the Federal and State regulation and supervision is substantially equivalent to the regulation and supervision of domestic banks. *Id.*

10. LETTERS OF CREDIT AND BANKERS ACCEPTANCES 469 (Practicing Law Institute 1986).

treatment of standby letters of credit.[11] Letters of credit are construed according to applicable law and custom. Article 5 of the Uniform Commercial Code ("U.C.C.") represents letter of credit law in all fifty states and the District of Columbia.[12] The Uniform Customs and Practice for Documentary Credits issued by the International Chamber of Commerce ("U.C.P.") sets forth the custom (although it is not the exclusive source thereof) governing bank documentary credits.[13] The U.C.P. is not a statute. The application of the U.C.P. to commercial transactions is conditional on its incorporation into the credit. The U.C.C. and the U.C.P. do not mirror each other. The U.C.P., which generally sets forth a set of standards for banks in international trade transactions, covers areas which Article 5 of the U.C.C. does not address.[14] Article 5 of the U.C.C., which provides a skeletal framework governing the relationships among all parties to a letter of credit transaction, contains provisions which the U.C.P. does not cover.[15] In most other respects, the U.C.P. and Article 5 of the U.C.C. contain similar provisions although there are a few areas of variance.[16] These differences can be

11. Standby letters of credit are generally subject to lending limits upon issuance while commercial credits are not. *See* 12 C.F.R. § 32 (1989) (governing national banks); and 12 C.F.R. § 337.2 (1989) (governing state banks which are not members of the Federal Reserve System). In addition, the three federal bank regulatory agencies, the O.C.C., the Federal Reserve and the FDIC have recently enacted regulations governing bank capital adequacy which assign different percentages of risk to different types of instruments. Standbys which guarantee payment of a debt are assigned a risk percentage of 100 percent; standbys which guarantee performance of an obligation other than the payment of money are assigned a risk percentage of 50 percent; and trade credits are assigned a risk percentage of 20 percent. 12 C.F.R. Pts. 3, 208, 325 (1989).

12. The Comptroller of the Currency has also promulgated regulations delineating the elements necessary for a letter of credit from a safety and soundness perspective. Under 12 C.F.R. § 7.7016 (1989), these elements are: (a) the letter of credit should conspicuously state that it is a letter of credit, or be conspicuously entitled as such; (b) the letter of credit should contain a specified expiration date or be for a definite term; (c) the letter of credit should be limited in amount; (d) the bank's obligation to pay should arise only upon presentation of specified documents; and (e) the account party should have an unqualified obligation to reimburse the bank.

13. The U.C.P. is revised periodically and the present version of the U.C.P. is the 1983 Revision, I.C.C. Pub. No. 400. The letter of credit in *Northern Trust* incorporated Pub. No. 290 (1974 Revision). The I.C.C. Commission on Banking Technique and Practice is currently exploring the possibility of adopting a new version of the U.C.P. *See* Katz, *ICC in Action: U.C.P., E.D.I., Guarantee Rules out Current Attention*, LETTER OF CREDIT UPDATE (Int'l Ed.), May 1989, at 7-11. The U.C.C. makes no mention of the U.C.P., treating it under the general rubric of a trade code as defined by U.C.C. § 1-205(2) (1977).

14. *See, e.g.*, U.C.P. Pub. No. 290, arts. 17-13 (1974); U.C.P. Pub. No. 400, arts. 15-21 (1983) (exculpatory provisions); and U.C.P. Pub. No. 290, arts. 14-33 (1974), U.C.P. Pub. No. 400, arts. 22-42 (1983) (commercial document standards).

15. *See, e.g.*, U.C.C. § 5-114(2) (1977) (issuer's privilege not to honor credit).

16. These differences include: 1) revocability (U.C.P., Pub. 290, art. 3c (1974), U.C.P., Pub. 400, art. 7c (1983) provide that in the absence of an indication in the credit, the credit is revocable; Article 5 of the U.C.C. contains no such provision); 2) the time permitted for document review (U.C.P. Pub. 290, art. 8d (1974) and U.C.P., Pub. 400, art. 16c (1983) provide for a "reasonable time;" U.C.C. § 5-112(1)(a) (1977) allows three banking days following receipt of documents); and 3) transferability (the U.C.P., Pub. 290, art. 46e (1974) and U.C.P. pub. 400, art. 54e (1983) permit a transferable credit to be transferred only once; Article 5 of the U.C.C. contains no such limitation).

resolved through the wording of the credit itself. The U.C.P. and Article 5 of the U.C.C. obligate the issuer to pay the beneficiary when it presents documents that comply with the credit.[17] This holds true regardless of any disputes between the beneficiary and the account party with respect to their underlying contract.[18] Most courts have held that the beneficiary must present documents that strictly comply with the terms of the credit and that the issuer may dishonor demands for payment which do not so comply.[19]

A. Confirmations

Parties other than the issuer may also become involved in letter of credit transactions by confirming the credit (a "confirmer").[20] Confirmations are used for a variety of reasons. First, in the purchase and sale of goods in international markets, the account party usually obtains a credit from its local bank. That bank, however, may not have an international reputation, thereby

17. U.C.P., Pub. No. 400, art. 10 (1983), U.C.C. § 5-103, 5-104, 5-105.

18. The U.C.C. contains the only generally accepted exception to this rule, which provides that when "there is fraud in the transaction . . . an issuer acting in good faith may honor the draft or demand for payment . . . but a court of appropriate jurisdiction may enjoin such honor." U.C.C. § 5-114(a) (1977).

An issuer or confirmer may also dishonor a draft or demand on the basis of this section. *See, e.g.*, Airline Reporting Corp. v. First Nat'l Bank of Holland, 832 F.2d 823 (4th Cir. 1987). However, such actions are unusual and the majority of "fraud in the transaction" cases are decided in the context of an injunction action brought by the account party. The fraud involved must be of such a magnitude that it "has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served." Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 361, 366 A.2d 316, 324 (1975).

19. Strict compliance requires that presented documents adhere absolutely to the terms of the credit. The substantial compliance standard can be viewed either as requiring compliance with the spirit, if not the letter, of the credit or as a construct by which hyper-technical documentary deficiencies will not result in nonpayment. The majority of jurisdictions have adopted the so-called "strict compliance" standard. *See* Corporacion de Mercadeo Agricola v. Mellon Bank Int'l, 608 F.2d at 43. However, a minority of jurisdictions have adopted the "substantial compliance" rule. *See* Banco Espanol de Credito v. State St. Bank & Trust Co., 385 F.2d 230 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968).

20. The U.C.C. speaks solely in terms of a "confirming bank" as "a bank which either engages that it will honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank." U.C.C. § 5-103 (1)(f) (1989). In Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224 (5th Cir. 1973), *cert. denied*, 414 U.S. 1139 (1974), the court held that a bank can confirm a credit issued by a non-bank. Although no other cases have considered whether non-banks can issue, advise or confirm credits, such actions are regularly undertaken by such entities, and commentators have suggested that such actions are consistent with the general policy of the U.C.C. *See* J. DOLAN, THE LAW OF LETTERS OF CREDIT § 1.03 (1989). For this reason, the Report of the Task Force on the Study of U.C.C. Article 5, presented to the Letter of Credit Subcommittee of the Uniform Commercial Code Committee of the American Bar Association's Business Law Section, recommends that the terms "issuer," "confirmer," "advisor" and "negotiator" be substituted for the present U.C.C. Article 5 terms "issuing bank," "confirming bank," "advising bank" and "negotiating bank." *See* An Examination of U.C.C. Article 5 (letters of credit); Report of the Task Force on the study of U.C.C. Article 5 (Sept. 29, 1989) (hereinafter *Task Force Report*).

making its credits unacceptable in foreign markets.[21] Second, the beneficiary may want to present its documents to a known bank in the geographical area of the beneficiary that has an independent payment obligation.[22] Insofar as domestic transactions are concerned, the beneficiary may want an independent obligation of an entity that it perceives to be more solvent than the issuer.

Although the U.C.C. speaks solely in terms of banks as confirmers, it should be noted that other entities may issue confirmations.[23] The U.C.C., however, does not discuss when a confirmation takes effect. Under the U.C.C., a credit takes effect with regard to the account party when the credit (or an authorized written advice) is sent to the beneficiary.[24] As to the beneficiary, the credit takes effect when the beneficiary receives it.[25] These same rules should apply to the confirmer; however, no substantive authority supports this proposition.[26] A confirmer undertakes the same obligations as the issuer and ensures that the issuer or another party will perform those obligations.[27] The confirmer also becomes directly and independently liable to the extent of its confirmation and acquires "the rights of an issuer" to the extent of its confirmation.[28] Generally, the account party does not have a direct relationship with the confirmer. Many jurisdictions, therefore, hold that the confirmer owes no duties to the account party unless a direct contractual relationship exists between the confirmer and the account party.[29] As a result, the confirmer is not bound by any contractual obligation to the

21. *See* J. DOLAN, *supra* note 20, § 1.03.

22. The beneficiary's desire to obtain a local confirmation has created an instrument commonly known as a "silent" confirmation. A silent confirmation occurs when a local bank adds its confirmation to a credit without the knowledge or authority of the issuer often because the issuer is unwilling or reluctant to permit its credits to be confirmed. Although there is no decisional or administrative law regarding this practice, the *Task Force Report* addresses this issue. *See Task Force Report, supra* note 20, at ¶ 10. The report opines that "[a] confirmation made without the authority of the issuer is not a true confirmation. ... The silent confirmer does not acquire the rights of an issuer on the original credit and is not a confirmer in any sense of the term." *Id.*

23. *See supra* note 20 and accompanying text.

24. U.C.C. § 5-106(1)(a) (1977).

25. U.C.C. § 5-106(1)(b) (1977).

26. J. DOLAN, *supra* note 20, § 5.01(5); see also *Task Force Report, supra* note 20, § 17 (rev. ed. Mar. 4, 1989) (unpublished manuscript).

27. U.C.C. § 5-103(1)(f) (1977); U.C.P., Pub. No.290, art. 3b (1984); U.C.P., Pub. No.400, art. 10b (1933).

28. U.C.C. § 5-107(2) (1989); Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461 (2d Cir. 1970). The rights of a confirmer include the right of reimbursement from the issuer as the confirmer's customer under U.C.C. § 5-103(1)(g) and as "the party giving such authority" under U.C.P., Pub. No. 400, art. 16a (1984).

29. Instituto Nacional de Comercializacion Agricola (Indeca) v. Continental Illinois Nat'l Bank & Trust Co., 530 F. Supp. 279 (N.D. Ill. 1982), *modified*, 675 F. Supp. 1515 (N.D. Ill. 1987), *aff'd*, 858 F.2d 1264 (7th Cir. 1988); Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co., 612 F. Supp. 1533 (S.D.N.Y. 1985), *aff'd*, 808 F.2d 209 (2d Cir. 1986); Cf. Auto Servicio San Ignacio, S.R.L. v. Compania Anonima Venezolana de Navegacion, 765 F.2d 1306 (5th Cir. 1985).

account party with respect to the standard of document review or of good faith, and the account party has no contractual claim against the confirmer arising out of the credit transaction.[30] Additionally, the confirmer has no right to seek reimbursement from the account party.[31] In a bankruptcy context, however, at least one court has given a confirmer a right of subrogation against the account party.[32]

B. Illustrations of Letter of Credit Principles

Two examples using a standard commercial transaction and letters of credit illustrate the foregoing principles.

1. Example 1 - Standard Commercial Practice[33]

Assume that a manufacturer of surgical gloves in Malaysia agrees with a medical supply company in Los Angeles to sell a specific quantity of gloves for $50,000 U.S. dollars. The manufacturer will ship all the gloves by sea at the same time, and they must leave Malaysia by July 1st. The buyer obtains a letter of credit from its bank, First U.S. Bank, to pay for the gloves. First U.S. Bank advises[34] the credit through its correspondent, First Malaysia Bank, which also confirms the credit using the wording, "we hereto confirm the above-referenced letter of credit."

The letter of credit provides that the beneficiary must present a draft, invoice, packing list, inspection certificate, any necessary visas and original "on-board" bills of lading[35] before July 15th (the expiry date). When the beneficiary ships the gloves, it will have all of the documents necessary to draw on the letter of credit. Although the beneficiary has the right to present the documents to either the confirmer or the issuer, in all likelihood, the beneficiary will present them to the confirmer due to its geographical proximity. The confirmer will then review the presented documents and, if the documents comply with the credit, will pay the beneficiary. The confirmer will then send the documents to the issuer. If the issuer finds that the

30. Almatrood v. Sallee Int'l, Inc., No. 83 Civ. 1800, (S.D.N.Y. May13, 1985).

31. See Instituto Nacional de Comercialicacion Agricola (Indeca) v. Continental Illinois Nat'l Bank & Trust Co., 858 F.2d 1264 (7th Cir. 1988).

32. Chemical Bank v. Broward (In re Glade Springs, Inc.), 826 F.2d 440 (6th Cir. 1987).

33. *See* Appendix A.

34. As no relationship exists between the issuer and the beneficiary, an "advisor", a bank located near the beneficiary, is used as an intermediary. An advisor receives the transmission of the letter of credit, authenticates the information received and delivers the credit to the beneficiary. The advisor's duties under U.C.C. § 5-107(1) are to advise accurately, and to authenticate the credit. U.C.P., Pub. No. 400, art. 8 (1983). This duty is in favor of the beneficiary and, under certain circumstances, the issuer. Sound of Mkt. St., Inc. v. Continental Bank Int'l, 819 F.2d 384 (3d Cir. 1987); Auto Servicio San Ignacio, S.R.L. v. Compania Anonima Venezolana de Navegacion, 765 F.2d 1306 (5th Cir. 1985).

35. *See* U.C.P., Pub. 290, art. 20 (1974); U.C.P. Pub. 400, art. 27 (1983).

documents comply with the credit, it will reimburse the confirmer. The issuer will then notify the account party that it has received the documents and will release the documents to the account party when the confirmer has been reimbursed. The account party can then obtain the surgical gloves and proceed with its business.

2. Example 2 - Anomalous Commercial Practice[36]

Assume the same facts as in Example 1. However, rather than presenting the documents to the confirmer, the beneficiary mails the documents directly to the issuer on July 1st, the last permitted shipment date.[37] Assume that the mailed documents arrive at the issuer's counters on July 14th. Then, on July 15th, the Federal Deposit Insurance Corporation ("FDIC") is appointed receiver of First U.S. Bank, which is insolvent. On July 16th, the confirmer automatically eliminates the liability represented by the confirmation from its books. On July 17th, the goods reach Los Angeles and are held in the local customs warehouse. On July 18th, the account party calls the bank to inquire about the status of the goods and learns that the issuer is in receivership. On July 20th, the beneficiary sends a telex to the issuer inquiring about the status of payment but receives no response. On July 21st, the account party agrees to pay the issuer the amount drawn under the letter of credit, obtains the tendered documents and removes the goods from the customs warehouse to its warehouse for delivery to its customers. On August 1st, the beneficiary receives a letter from the FDIC "disaffirming" the letter of credit. The beneficiary then delivers a letter to the confirmer stating that it has made presentment of documents to the issuer, that pursuant to the terms of the confirmation such presentment also constituted presentment to the confirmer and demands payment. The confirmer, who has already eliminated the liability from its books, has had no opportunity to review the documentation (which has been released to the account party in Los Angeles). Furthermore, if the confirming bank pays on the confirmation, it does so at its own risk. The goods, which would otherwise secure the reimbursement obligation, have been released to the account party. The confirmer finds itself in a difficult if not untenable position. Such position is reflected in the *Northern Trust Company v. Community Bank* decision.

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36. *See* Appendix B.

37. By going outside the international banking network, the beneficiary has subjected itself to the risk of nonpayment if the mail does not arrive in Los Angeles on or before July 15th, the expiry date.

III. NORTHERN TRUST COMPANY

The Facts

The *Northern Trust Company v. Community Bank*[38] decision may significantly change the nature of the confirmer's duties with respect to credit transactions. The facts of the case were undisputed by the parties. In December 1981, West Coast Bank ("West Coast") issued its standby letter of credit in favor of The Northern Trust Company ("Northern"). Community Bank ("Community") confirmed the credit which had an expiry date of December 31, 1985. The credit provided that it was subject to the U.C.P. The letter of credit required presentment of a draft, a signed statement certifying the occurrence of specified events and the original letter of credit.

In 1985, the California Superintendent of Banks closed West Coast and appointed the Federal Deposit Insurance Corporation ("FDIC") as receiver for the bank. Thereafter, in November 1985, Northern presented a demand for payment under the letter of credit to West Coast. The presented documents complied with the terms of the credit. In January 1986, the FDIC informed Northern that it would not honor the letter of credit, but that Northern could make a claim against the receivership estate.[39] In February 1986, Northern presented a demand under the letter of credit to Community through correspondence that was unaccompanied by any other documents. Community refused to honor the demand because the credit had expired. Northern sued Community for wrongful dishonor.

The Arguments

Northern's principal argument was that Community, as a confirmer, assumed an obligation to honor the credit in strict accordance with its terms, including those governing presentment. This argument was based on language in the U.C.P. which states that a "confirmation constitutes a definite undertaking of the confirming bank in addition to the undertaking of the issuing bank, provided that the terms and conditions of the credit are complied with."[40] Northern argued that this language did not create separate, independent obligations of issuer and confirmer; the words "in addition to" did not imply that the obligation of the confirmer differs in any way from that of the issuer. Thus, under the terms of the credit, when Northern presented documents to West Coast, it had also made constructive presentment to Community.

38. 873 F.2d 227 (9th Cir. 1989).
39. U.C.P., Pub. 290, art. 3b (1974); U.C.P., Pub. 400, art. 10b (1983).
40. U.C.P., Pub. 290, art. 3b (1974); U.C.P., Pub. 400, art. 10b(b) (1983).

In addition, Northern argued that separate, independent presentation of documents would be contrary to governing law and the principle of "strict compliance." Because the letter of credit explicitly required presentment of documents to West Coast, this was the extent of Northern's obligation and hence Northern was entitled to draw under the confirmation. Community also relied on the doctrine of strict compliance, arguing that it had no liability to Northern. Community contended that strict compliance with the terms of the letter of credit meant strict compliance with the expiry date, notwithstanding any other actions by the beneficiary. Although Northern presented the documents to West Coast prior to the expiry date, Community argued that a confirmer only becomes obligated to pay on a letter of credit when it has received an independent presentment of documents.

Also citing the U.C.P., Community stated that a confirmer acquires, to the extent of its confirmation, the rights and obligations of the issuer.[41] Community also cited Section 5-107(2) of the California version of the Uniform Commercial Code which states, in part, that "a confirming bank . . . becomes directly obligated on the credit ... as though it were its issuer and acquires the rights of its issuer."[42] The official comment to this section states that "a beneficiary who has received a confirmed credit has the independent engagements of both the issuer and the confirming bank."[43] Community concluded from these sections that the obligations and rights of an issuer and confirmer are equal and independent, thereby requiring a separate and independent presentment of documents to each entity.

The Decision

The district court granted summary judgment in favor of Northern. That court, interpreting Section 5-107(2) of the U.C.C., found that as a matter of law, neither the U.C.P. nor Article 5 of the U.C.C. require separate presentment of documents to the issuer and the confirmer. Therefore, as the letter of credit did not require Northern to make a separate, independent presentment of documents to Community, a timely presentment to West Coast obligated Community to pay on its confirmation. The appellate court af-

41. U.C.C. § 5-107 (1977).

42. U.C.C. § 5-107, comment 1 (1977).

43. Standing in the shoes of a failed bank which issued a standby letter of credit, the FDIC has a policy to "disaffirm" each such credit. This policy is based on the theory that the beneficiary of a standby credit does not have a provable claim against the issuer. *See generally* J. DOLAN, *supra* note 20, § 12.02(1). This position, however, has been rejected by the courts. Philadelphia Gear Corp. v. FDIC, 751 F.2d 1131 (10th Cir. 1984), *rev'd on other grounds*, 476 U.S. 426 (1986). *See also* FDIC v. Liberty Nat'l Bank & Trust Co., 806 F.2d 961 (10th Cir. 1986) and Bryant v. Kerr, 726 S.W.2d 373 (Mo. Ct. App. 1987). This position is to be contrasted with the FDIC's approach as successor to failed banks which were beneficiaries of letters of credit. *See* FDIC v. Bank of Boulder, Fed. Banking L. Rep. (CCH) ¶ 87, 470 (10th Cir. 1988).

firmed the holding. The court reached its conclusion notwithstanding a showing that industry custom does require a separate presentment of documents. In its reasoning, the court relied on one case and a secondary source containing sample letters of credit forms.[44] The court found that these materials implied that, in the absence of express language, no independent presentment of documents would be required. This is a leap of faith not warranted by the cited materials. In fact, one of the forms cited, a confirmed irrevocable negotiation credit, which was the same type of credit at issue in the case, did not contain any such requirement.[45]

Analysis

Although the court's decision may be consistent with the literal language of the statute or trade code, it conflicts with industry custom and usage. Section 5-107(2) of the U.C.C. states that:

> A confirming bank by confirming a credit becomes directly obligated on the credit to the extent of its confirmation as though it were its issuer and acquires the rights of its issuer.[46]

Similarly, Article 3b of the 1974 revision of the U.C.P. states that:

> when an issuing bank authorizes or requests another bank to confirm its irrevocable credit and the latter does so, such confirmation constitutes a definite undertaking of the confirming bank in addition to the undertaking of the issuing bank, provided that the terms and conditions of the credit are complied with.[47]

Neither of these provisions expressly address the issue presented. It should be noted, however, that the words "in addition to the undertaking of the issuing bank" in Article 3b of the U.C.P. were not included in the prior revision of the U.C.P. and, as suggested by one expert, were added in the 1974 revision in order to make it clear that the confirmer and issuer have separate and independent obligations.[48]

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44. Barclays Bank v. Mercantile Nat'l Bank, 481 F.2d 1224 (5th Cir. 1973); H. HARFIELD, BANK CREDITS AND ACCEPTANCES 324-25 (5th ed. 1974).

45. H. HARFIELD, *supra* note 44. One noted authority, Charles del Busto, Senior Vice President of Manufacturers Hanover Trust Company and Chairman of the International Chamber of Commerce Commission on Banking Technique and Practice, has written that the use of a brief and simple statement to establish a confirmation, such as that used in the Northern Trust case, is a result of banks throughout the world using the ICC Standard Documentary Forms, which were developed to accommodate electronic banking. del Busto, *N.Y. Banker del Busto Reviews Confirming Obligations of Banks*, 5 LETTER OF CREDIT UPDATE, Aug. 1989, at 6.

46. U.C.C. § 5-107(2) (1977).

47. U.C.P., Pub. 290, art. 3b (1974).

48. A declaration submitted by Boris Kozolchyk in *Northern Trust*, stated:

> One of the purposes of this revision was to put to rest the mistaken notion of some interpreters that the terms 'irrevocable' and 'confirmed' were synonymous and carried similar legal effects, i.e. to make it clear that the obligation of the confirming bank was separate and independent from the obligation of the issuing bank. See

The Commentary following section 5-107(2) of the U.C.C. states that "the most important aspect of this rule is that a beneficiary who has received a confirmed credit has the independent engagements of both the issuing and the confirming bank."[49] It should be noted that, as discussed previously, confirmations developed, in part, in order to provide the seller of goods with a local funding source. Thus, the inherent nature of the confirmation was the desire to accommodate the beneficiary. A confirmed credit permits the beneficiary to present documents to a familiar, local financial institution, thereby assuring speedier payment than would be available if presentment were limited to the issuer's counters. There are two reasons why industry custom has generally required separate and independent presentments to the issuer and the confirmer. First, the confirmer has a right to control its outstanding liabilities. Under the *Northern Trust* decision, a confirmer is never absolved of liability so long as presentment has been made to the issuer before the expiry date. This is true even if the confirmer was not aware of any presentment to the issuing bank. Second, under *Northern Trust*, confirmers will be unable to determine the expiry dates of their credits or confirmations and effectively ascertain their outstanding liabilities. Courts have generally required beneficiaries to strictly comply with stated expiry dates.[50] Bank regulations specifically require an expiration date or a definite term.[51] The U.C.P. also requires all credits to stipulate an expiry date and that all documents be presented on or before that date.[52] If the expiry date is indeterminable, compliance with regulations that require reporting of credits and maintenance of specified capital levels would be difficult.[53] Also, collateral posted with confirmers to secure reimbursement obligations of issuers could never be released under this rule. The U.C.P. also requires banks to "examine all documents with reasonable care to ascertain whether they appear, on their face, to be in accordance with the terms and conditions of the credit."[54] To do that, banks must receive the required documents and be given an opportunity to review them. Under *Northern Trust*, however, the confirmer is deemed to have received presentment when it was made

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Kozolchyk, Chapter 5, Letters of Credit International Encyclopedia of Comparative Law, 111 (Tubinjen, 1978)....

See Memorandum of Points and Authorities in Opposition to Plaintiff's Motion for Summary Judgment at 12, Northern Trust Co. v. Community Bank, 873 F.2d 227 (9th Cir. 1989) (Declaration of Boris Kozolchyk, Dec. 17, 1987).

49. U.C.C. § 5-107 comment 2 (1977).

50. INA v. Heritage Bank, N.A., 595 F.2d 171 (3d Cir. 1979); Hyland Hills Metro. Park & Recreation Dist. v. McCoy Enters., Inc., 38 Colo. App. 23, 554 P.2d 708 (1976); *see also* J. DOLAN, *supra* note 20, § 5.03(3)(e).

51. 12 C.F.R. §7.7016 (1989).

52. U.C.P., Pub. No. 290, art. 37 (1974); U.C.P., Pub. No.400, art. 46 (1983).

53. *See supra* note 11.

54. U.C.P., Pub. No. 400, art. 15 (1983).

solely to the issuer. This is the case even if the confirmer did not receive the documents or have an opportunity to review them.

The examples discussed above illustrate these problems. In Example 1, it was assumed that the beneficiary would present documents to the confirmer by July 15th. An elaboration on Example 2 illustrates another dilemma faced by confirmers in light of *Northern Trust*. Suppose that the beneficiary actually presents documents directly to the issuer on July 14th (the day before the expiry date). Also, suppose that the issuer does not pay the beneficiary, does not notify the beneficiary of its reasons for nonpayment and does not return the documents to the beneficiary.[55] Now suppose that the account party has determined that it does not want the goods and does not want its bank to pay on the letter of credit. The account party does not have this right. As a practical matter, however, it is not uncommon for the account party to request his bank not to pay drafts presented with respect to goods which the account party no longer wants.[56]

In all likelihood, on July 15th, the confirmer, not having received any demand for payment, will delete its obligation under the confirmation from its books and records. Assume that the beneficiary and the issuer have extensive discussions regarding payment under the letter of credit but by October 1st, no settlement has been reached. At that point, the beneficiary sends a letter to the confirmer demanding payment under the letter of credit and asserting that the documents presented to the issuer strictly complied with the terms of the credit.

The confirmer faces several problems under this scenario. First, the confirmer is being asked by the beneficiary to fund an obligation not shown on its books and records. Second, the confirmer has no opportunity to review documents to determine whether payment is due.[57] Third, the confirmer does not have the original documents required by the credit. Therefore, if payment is made, the confirmer's right of reimbursement will be unsecured.

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55. *See supra* note 17.

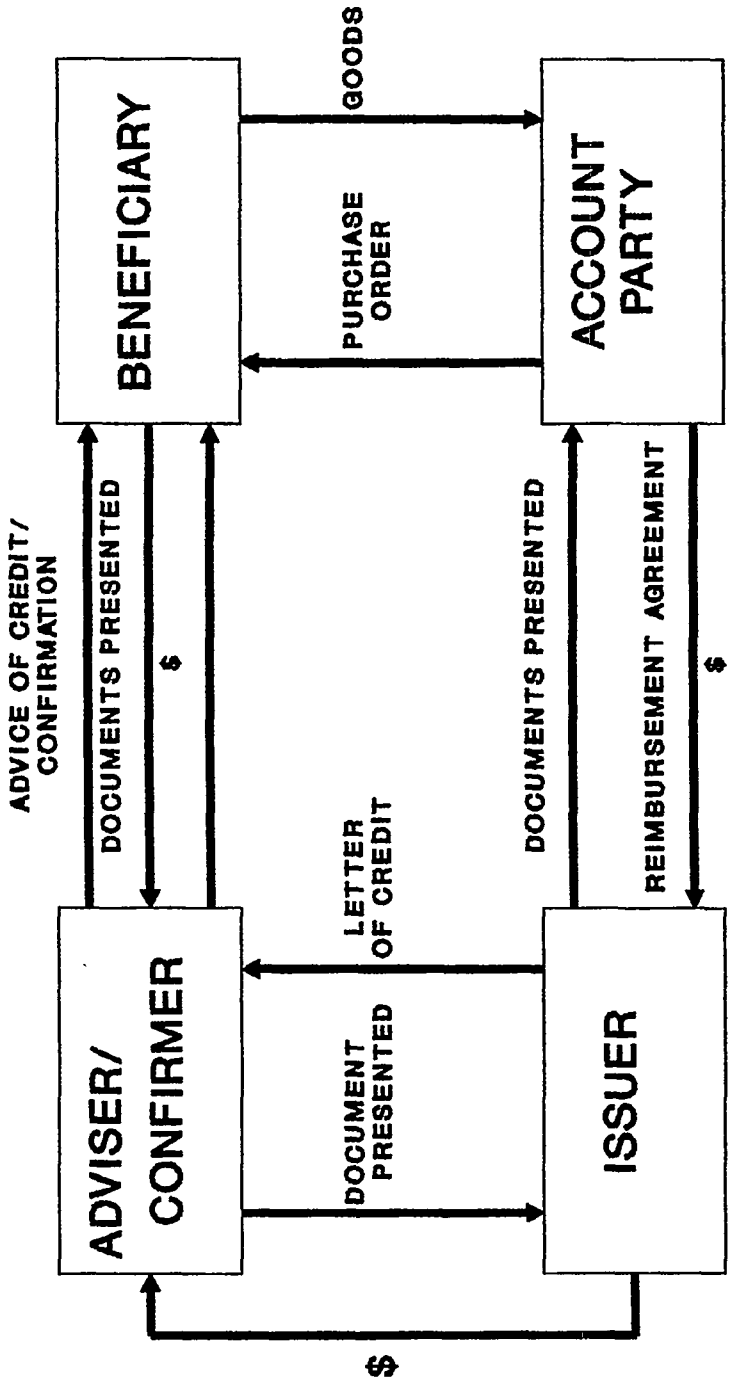
56. It should be noted that if the confirmer pays against non-conforming documents it may not be entitled to reimbursement from its customer, the issuer. *See* Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co., 612 F. Supp. 1533, 1540 (S.D.N.Y. 1985), *aff'd*, 808 F.2d 209 (2nd Cir. 1986) ("[A]n issuing bank's action for wrongful honor against a confirming bank is governed by a strict compliance standard"); Seattle-First Nat'l Bank v. FDIC, 619 F. Supp. 1351, 1362 (W.D. Okla. 1983) ("[T]he confirming bank owes to its customer, the issuer, a duty of careful documentary examination under UCC § 5-109 . . . .").

57. Article 16 of the U.C.P., Pub. No. 400 (1983), provides that if the issuer decides not to pay on its letter of credit (as a result of its review of the presented documents), it must so notify the beneficiary or presenting bank stating the discrepancies in the documents. If the issuer does not act in accordance with this rule, it is "precluded from claiming that the documents are not in accordance with the terms and conditions of the credit." *Id.* This rule was not necessarily relevant in Northern Trust due to the intervening insolvency of the issuer.

IV. CONCLUSION

The Court in *Northern Trust* stated that problems, like the ones described in this article, could easily be eliminated by including a requirement of independent presentation in the form of confirmation. Unfortunately, this solution appears to be at odds with standard industry practice, notwithstanding the Court's citations to the contrary. Additionally, it would seem that the confirmer's right to control its outstanding liabilities and to review original, presented documents should not be abrogated absent the confirmer's express agreement. *Northern Trust*, however, will remain the governing law on this issue absent statutory revision or revision of the U.C.P. Banks, which act as confirmers, should therefore take note of the *Northern Trust* decision and should revise their form of confirmation to require separate presentment. For confirmers who remain unaware of the *Northern Trust* decision or have issued outstanding confirmations, this current law remains a trap for the innocent.

APPENDIX A


BENEFICIARY
ACCOUNT PARTY
ADVISER/ CONFIRMER
ISSUER
GOODS
PURCHASE ORDER
ADVICE OF CREDIT/ CONFIRMATION
DOCUMENTS PRESENTED
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LETTER OF CREDIT
DOCUMENT PRESENTED
DOCUMENTS PRESENTED
REIMBURSEMENT AGREEMENT
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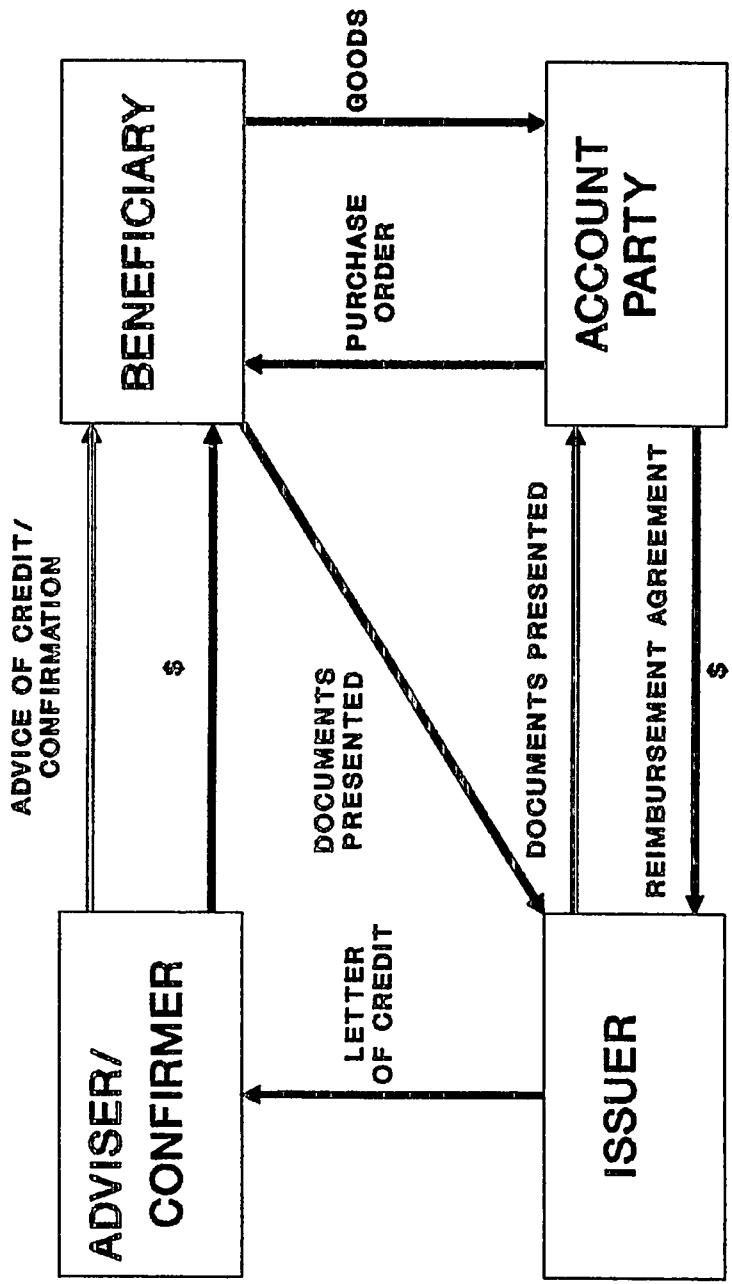
APPENDIX B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LETTER OF CREDIT
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REIMBURSEMENT AGREEMENT
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