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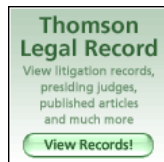
Letter of Credit Litigation

By [Hoguet Newman & Regal, LLP](#)

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Letter of credit law in the United States is a highly specialized discipline. Although a letter of credit is a contract, the usual rules do not always apply. It is a mercantile specialty with rigorous, formalistic requirements that has developed independently of the common law of contracts. Financial institutions and larger trading companies have in-house staffs with the requisite expertise in this highly technical and arcane area. All others are at risk because of the severe transactional penalties that may attach to a misunderstanding or a misstep. Our court records are replete with letter of credit decisions where one of the parties has been disadvantaged by its lack of sophistication in this area. Indeed, many US courts do not understand letter of credit law, creating additional peril for the unguided.

Recent letter of credit litigation underscores the need for sophisticated legal counsel. For example, Lloyd's of London has been in the centre of a spate of litigation in the United States, and elsewhere, over its attempts to draw on standby letters of credit issued as security for the account of Names who have left unmet Lloyd's cash calls to meet the demands of mounting insurance liabilities over recent years. In an attempt to avoid incurring bankrupting obligations to reimburse their banks for paying on the letters of credits, many Names have sought to enjoin their banks from paying these demands, and they have done so alleging fraud (for example, an alleged understatement by Lloyd's of liabilities arising from pollution and asbestosis claims) so as to trigger the so-called fraud injunction against honour. In many of these instances Lloyd's was not even named as a defendant in the US litigation.

Letter of credit applicants have increasingly been able to prevent payment in the United States by obtaining court orders enjoining their US banks from paying demands under their letters of credit on the ground of fraud. Often a court will issue a temporary or preliminary injunction in the absence of the beneficiary, with only the letter of credit applicant and the issuer bank as parties, leaving the beneficiary to learn of the development when it receives a notice of dishonor from the issuing bank advising that it has refused payment due to the court order.

In this situation, the beneficiary will want to move quickly to intervene in the court proceeding to contest the claim of fraud or, as Lloyd's has successfully done in some of its US litigation, to dismiss the litigation for jurisdictional flaws. The issuing bank might resist an injunction against payment, in the interest of preserving its reputation and the continued marketability of its letters of credit as reliable sources of payment. However, the safest course is for the beneficiary to seek to intervene in the litigation and press its own arguments as to why there is no fraud and why the issuing bank is obligated to pay.

Injunctions against honour

As to the matter of the claim of fraud, the prevalence of injunctions against honour on the ground of fraud is a phenomenon of US jurisprudence, although such injunctions are not unknown in other jurisdictions. The injunction against honour is an exception to the principle of independence, one of the most basic tenets of letter of credit law and practice. The classic letter of credit transaction consists of three separate and distinct contractual relations:

1. the underlying contract which gives rise to the letter of credit;
2. the contract between the issuing bank and the applicant for the letter of credit, whereby the bank undertakes to issue the letter of credit; and
3. the letter of credit itself, whereby the issuer undertakes to pay the beneficiary upon a complying demand.

Each of these relationships, under letter of credit law, is entirely independent of the others, and the rights and obligations of the parties to one are not affected by the breach of, or anything to do with, any of the others. This means that, so long as the documents presented comply in all respects with the terms of the letter of credit, and presentation has been duly made before expiration of the credit, the issuer must honour the demand even if the beneficiary has breached its duty to the applicant or even if the applicant is unable to reimburse the bank for its payment. These are ancillary matters, which, in the ordinary course, are to be dealt with after payment.

The independence principle has long been reflected in the Uniform Customs and Practice for Documentary Credits (the UCP), a compilation of internationally accepted banking customs and practice regarding letters of credit promulgated by the International Chamber of Commerce in 1930 and revised periodically thereafter. While the UCP is not law, it will apply to most letters of credit because most issuers expressly incorporate it into their letters of credit. The principle also finds expression in Article 5 of the Uniform Commercial Code (the UCC), a uniform statutory scheme governing letters of credit adopted in each of the states of the United States. UCC Article 5 recognizes an exception to the independence principle,

providing that a court may enjoin honour of a payment demand when a required document presented under the letter of credit is forged or fraudulent or where there is fraud in the transaction (or, in the 1995 version of Article 5 adopted in many states, where the document is forged or materially fraudulent or payment would facilitate a material fraud). While the UCP has no counterpart to this provision, letters of credit subject to the UCP are still subject to an injunction against honour on the ground of fraud in litigation in the United States. The fraud exception, if applicable, can also be relied upon by the issuer as a reason to refuse payment without court order.

Resolution of the litigation will depend on whether the applicant establishes fraud. This will depend on the facts of each case, but the litmus test applied by the courts is whether the problem amounts to a breach of contract or breach of warranty, in which case the independence principle should require payment of a proper demand, or whether there has been "egregious" fraud that, as one oft-quoted case put it, "has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligations would no longer be served," (*Intraworld Industries Inc v Girard Trust Bank*). Payment, if the beneficiary can establish entitlement to it, will have to await a satisfactory resolution of the litigation.

Minimizing the risks

There are a few precautions that can be taken before a letter of credit is issued to avoid interruption of payment. One possibility is for the beneficiary to insist that the letter of credit be confirmed by an acceptable bank in its location. Then the beneficiary can be paid without recourse by the confirming bank. The letter of credit applicant cannot so readily enjoin the confirming bank from paying because he may not learn of the presentment in time to do anything before payment, because the US court may not have personal jurisdiction over the confirming bank and because courts outside the United States are far less likely to permit injunctions against honour on the ground of alleged fraud. An injunction against the US issuing bank will not, in and of itself, affect the confirming bank's obligation to pay, although the confirming bank may be displeased with the prospect of a possible battle with the issuing bank over reimbursement for its payment.

Another possibility is for the beneficiary to insist on the issuance of a negotiation credit, which obligates the issuer to pay any holder of a draft drawn under the letter of credit. Then, again, the beneficiary can be paid without recourse upon presentation to a local bank (although the payment will probably be arranged at a reasonable discount), provided that the local bank agrees to take and pay for the documents. The local bank, negotiating bank, would then present to the issuing bank, which would be bound to pay notwithstanding any alleged fraud in the underlying transaction if the negotiating bank qualifies as a holder in due course of conforming documents with no notice of fraud. While the local bank may become embroiled in litigation to recover payment from the issuing bank, the local bank may well be better able to reach an accommodation with the issuer than the beneficiary.

While the very possibility of an injunction against honour may to some extent erode the predictability of letters of credit, they still provide a generally reliable means of swift and sure payment. The many pitfalls in letter of credit litigation in the United States can be avoided with expert guidance.

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