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Standby Letters of Credit and Guaranties: An Exercise in Cartography

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"Boundaries are not just drawn, they undergo a process of development."

The drafting of a Restatement of Suretyship provides a convenient opportunity for some cartography—that is, for mapping the borders between a standby letter of credit and a contract of guaranty. This mapping of borders is not only a timely exercise, it is also an important one. There are several reasons for this. First, in recent years, there has been an explosion in the use of both letters of credit and guaranties in financing transactions. Second, the precise differences between the two legal regimes are not always well understood by lawyers. Third, institutions—most notably U.S. banks—are usually empowered to issue standby credits but not guaranties. For these institutions, the issuance of a guaranty would normally be an ultra vires act. Thus, it is particularly important for bank issuers to be conscious of the differences between a standby letter of credit and a guaranty.

Part I of this Essay shows that, superficially at least, the borders between standby letters of credit and contracts of guaranty appear to be well settled. A standby letter of credit is a “beneficiary oriented” payment instrument that is both documentary in nature and independent of the overall financial transaction of which it is a part. A contract of guaranty, on the other hand, is a more “appli-
cant oriented” payment instrument that is nondocumentary in nature and dependent on the overall financial transaction.6

Part II demonstrates, however, that upon closer analysis, the borders between standby credits and contracts of guaranty are not so well settled as they may first appear. For example, either because of drafting or judicial construction, standby letters of credit are sometimes enforced using legal rules that are borrowed from the law of guaranty. In some situations, these standby credits are treated as retaining their character as letters of credit, while in other situations, they are treated as having become guaranties. Predicting in advance just how they will be treated is often difficult.

Part III shows, however, that ill-defined borders separating standby credits from contracts of guaranty are not necessarily problematic. Ill-defined borders usually indicate borders that are “undergoing a process of development.”7 Just as it is normal for those who reside along national borders to borrow from a neighboring culture, so too it is normal for letter-of-credit law to borrow from guaranty law, and vice versa.8 In fact, in recent years, courts have grown to tolerate, if not actually encourage, this borrowing.9

I. THE NATURE OF STANDBY LETTERS OF CREDIT AND CONTRACTS OF GUARANTY

The standby letter of credit and the contract of guaranty are both credit-enhancement devices.10 By nature, however, the standby letter of credit is “beneficiary oriented,” meaning that the

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6. See Guttman, supra note 5, at 168-71. For a succinct description of the differences between a standby credit and a guaranty, see Bank of North Carolina v. Rock Island Bank, 570 F.2d 202, 206 n.7 (7th Cir. 1978), rev’d, 630 F.2d 1243 (7th Cir. 1980); James J. White & Robert S. Summers, Handbook of the Law Under the Uniform Commercial Code 713-14 (2d ed. 1980).
7. Demko, supra note 1, at 66.
9. See infra part II.
standby credit favors the interests of the beneficiary of the credit who in most financial transactions will be the obligee/creditor. A contract of guaranty, on the other hand, is more "applicant oriented." "Applicant oriented" means that, when compared to a standby letter of credit, the contract of guaranty tends to favor the interests of the party applying for the guaranty (who in most financial transactions will be the obligor/debtor), rather than the party who is the beneficiary of the guaranty.

A. Standby Letters of Credit

To help understand the beneficiary-oriented nature of a standby letter of credit, let me describe a classic standby letter-of-credit transaction. Typically, a standby letter-of-credit transaction is composed of three separate and independent contracts. For example, assume that X and Y enter into a contract whereby X promises to build Y a house by June 1. X promises to pay Y $50,000 in liquidated damages if X fails to build the house by that date. To guarantee payment of that sum, Y requires that X have Solid Gold Bank issue a $50,000 standby letter of credit in favor of Y. The terms of the credit entitle Y to demand payment from Solid Gold Bank by presenting the bank with a $50,000 sight draft and a written certificate attesting to X's failure to complete the project.

11. See id. at 1-15 to -21. For a thorough definition of a standby credit, see id. Professor Dolan states:

The standby credit beneficiary . . . reasonably expects that he will receive cash in the event of nonperformance, that he will receive it promptly, and that he will receive it before any litigation with the obligor . . . takes place. The standby credit has the opposite effect of the surety contract: It reverses the financial burden of the parties during litigation.

Id. at 1-18.

12. The terms "beneficiary oriented" and "applicant oriented" were deliberately chosen in lieu of the terms "obligee oriented" and "obligor oriented" to describe relevant differences between standby letters of credit and contracts of guaranty. The reader will realize, however, that since the terms "beneficiary oriented" and "applicant oriented" are taken from letter-of-credit law, the terminology is new to contracts of guaranty.


14. For the purposes of this Essay, it will be assumed that the $50,000 represents legitimate liquidated damages and not a disguised penalty. See Gerald T. McLaughlin, Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy, 43 Ohio St. L.J. 1 (1982).
necessary construction of the house by June 1 and failure to pay the $50,000 in liquidated damages.

This contract between X and Y, whereby X must complete construction of the house by June 1, is the underlying contract, Contract I, that necessitates the issuance of the standby credit. The contract between X and Solid Gold Bank whereby X applies to the bank for the issuance of the standby credit and promises to reimburse Solid Gold Bank in the event that the bank must honor its letter-of-credit payment obligation is Contract II. Finally, Contract III is the actual standby letter of credit that is issued by Solid Gold Bank and established in favor of Y whereby Solid Gold Bank irrevocably obligates itself to pay Y $50,000 if Y presents the required sight draft and written certificate attesting to X's failure to complete the timely construction of the house and pay the liquidated damages amount.

There are two cardinal principles of letter-of-credit law. First, Solid Gold Bank's (issuing bank's) payment obligation to beneficiary Y under the letter of credit (Contract III) is documentary in nature; that is, Solid Gold Bank is obligated to pay beneficiary Y only if Y presents the necessary draft and written certificate attesting to X's default in advance of the expiry date of the credit. Second, absent fraud, Solid Gold Bank's payment obligation under Contract III is separate from, and independent of, the other contracts that generated it—Contract I (the construction contract between X and Y) and Contract II (the reimbursement agreement

15. The reimbursement contract—usually contained on the reverse side of the issuing bank's letter-of-credit application form—may also contain language whereby the applicant grants the issuing bank a security interest in certain collateral of the applicant to secure payment of the reimbursement obligation.

16. A letter of credit is "established" with respect to the beneficiary of the credit when the credit, or an authorized written advice of its issuance, has been received by the beneficiary. U.C.C. § 5-106(1)(b) (1990).

17. The documentary nature of a letter of credit is emphasized in the Uniform Customs and Practice for Documentary Credits. See International Chamber of Commerce, Pub. No. 400, Uniform Customs and Practice for Documentary Credits art. 4 (1983) [hereinafter U.C.P.]. Article 4 provides: "In credit operations all parties concerned deal in documents, and not in goods, services and/or other performances to which the documents may relate." Id.
between Solid Gold Bank as the issuer of the credit and X as the applicant for the credit).  

It is these two principles that mainly account for the beneficiary-oriented nature of a standby letter of credit. In deciding whether to honor its credit, the issuing bank is obligated to review only the facial compliance of the documents presented. The bank need not, and in fact may not, embroil itself in the time-consuming process of evaluating the facts that underlie those documents. Because the issuing bank undertakes an obligation to pay only against documents and not against the truth or falsity of the facts stated in those documents, the beneficiary of the credit is thereby assured of swift payment. Similarly, because the issuing bank undertakes a payment obligation that is independent of Contracts I and II, the beneficiary will be assured of payment despite the existence of disputes (other than those based on fraud) that arise with respect to the underlying contract (Contract I) or the reimbursement agreement (Contract II).

Of course, once the beneficiary of the credit has been paid and the issuing bank's Contract III payment obligation has been fully satisfied, nothing in letter-of-credit law prevents the rights of the beneficiary with respect to Contract I from being subsequently readjusted—either through negotiation or litigation. One thing is certain, however: during any subsequent negotiation or litigation, the beneficiary-oriented nature of a letter of credit means that the beneficiary will be the stakeholder of the proceeds of the letter-of-credit payment.

18. The independence principle is also set forth in the U.C.P. Article 3 provides: “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) . . . .” Id. art. 3; see also U.C.C. § 5-109(1)(b) (stating that an issuing bank is not liable for acts or omissions of parties other than itself); id. § 5-114(1) (stating that an issuing bank must honor a demand for payment that complies with the relevant terms of the credit, regardless of whether the underlying contract has been breached).
19. See supra note 18.
20. See U.C.C. § 5-114(1).
21. See id.
22. See id.
B. Contracts of Guaranty

A contract of guaranty is more applicant oriented in nature than a standby letter of credit. In its classic form at least, a contract of guaranty is nondocumentary, requiring the guarantor to honor its guaranty after evaluating not the facial conformity of documents, but rather the truth or falsity of facts. Similarly and almost as a corollary of what has just been said, a contract of guaranty is, therefore, dependent on the contracts that give rise to its issuance.

Assume again that X and Y enter into the aforementioned construction contract, the terms of which obligate X to complete Y's house by June 1 or pay $50,000 in liquidated damages if X fails to complete construction by that date. To secure payment of this sum, Y requires that X have a third party, Q, issue a $50,000 guaranty in favor of Y. Q's guaranty entitles Y to claim $50,000 from Q if X defaults on its obligation to complete construction of the house by June 1 and fails to pay Y the necessary $50,000 in liquidated damages. According to classic principles of guaranty law, Q's contract of guaranty (Contract III) is dependent upon the underlying construction contract (Contract I). Put another way, Q will be obligated to pay on its guaranty only if X in fact defaults on its obligations to complete construction of the house by June 1 and to pay the $50,000 in liquidated damages. If, for example, X were coerced by Y into accepting the June 1 completion date, then Q would not be required to honor its guaranty because X would not in fact have defaulted on its Contract I performance obligation and been required to pay Y $50,000 in liquidated damages. Because a contract of guaranty does not necessarily assure beneficiary Y of payment if disputes arise with respect to the underlying construction contract, it is to that extent less beneficiary oriented than a standby letter of credit. Looked at from the other side, because the contract of guaranty allows guarantor Q to utilize the defenses

25. See id.
of X, the principal obligor, as defenses to its own payment obligation, the guaranty is more applicant oriented in nature than the standby letter of credit.

II. THE ILL-DEFINED BORDERS BETWEEN LETTER-OF-CREDIT LAW AND GUARANTY LAW

Some types of payment obligations are not clearly either letters of credit or contracts of guaranty, but lie along the border separating the standby letter of credit from the contract of guaranty.\textsuperscript{27} These “borderland” obligations usually occur in one of two ways. First, parties may, either consciously or unconsciously, include in one form of payment obligation a term borrowed from the other type of payment obligation. The most common example of this is the parties’ inclusion of a nondocumentary payment condition in a standby letter of credit. Second, courts may enforce one type of payment obligation using procedural and substantive rules that fit more appropriately with another type of payment obligation.\textsuperscript{28} For example, a court might allow the issuing bank to interplead the beneficiary and the applicant before honoring its letter-of-credit payment obligation.

These “borderland” payment obligations are troublesome because they indicate that payment instruments are not always one thing or the other—they can sometimes partake of two cultures. They demonstrate that the borders between the standby credit and the contract of guaranty are not well settled. What is particularly problematic is that it is often difficult to predict what law a court will apply to one of these “borderland” instruments—letter-of-credit law, guaranty law, or a mixture of the two.

To show the ill-defined nature of the standby credit-guaranty border, three types of “borderland” payment obligations will be described in this Essay: standby letters of credit that contain nondocumentary payment conditions, standby letters of credit issued

\textsuperscript{27} See Bank of N.C. v. Rock Island Bank, 570 F.2d 202, 206 n.7 (7th Cir. 1978) (describing instances in which the distinctions between letters of credit and contracts of guaranty become blurred), rev’d, 630 F.2d 1243 (7th Cir. 1980).

\textsuperscript{28} See infra text accompanying notes 56-66.
subject to the Uniform Rules for Demand Guarantees\textsuperscript{29} (U.R.D.G.) and what I will call “quasi-standby letters of credit”—i.e., credits that are enforced using rules borrowed from another body of law that have the effect of either allowing or encouraging an applicant to present its case against payment of the credit before the beneficiary receives payment.

A. Standby Letters of Credit with Nondocumentary Payment Conditions

Occasionally, a bank will include a nondocumentary payment condition in a letter of credit. A nondocumentary payment condition can be defined as a term in a letter of credit that conditions payment not against the presentation of a document but, rather, against the ascertainment of the truth or falsity of some fact in that document.\textsuperscript{29} For example, a standby letter of credit may be drafted in such a way that the issuing bank obligates itself to pay if the applicant defaults on performing its underlying obligation. Here, the condition triggering the bank's obligation to pay is nondocumentary in nature—i.e., the issuing bank is obligated to pay only if it determines that the applicant has in fact defaulted; its payment obligation is not triggered by the presentation of a document attesting to the applicant’s default. Thus, the inclusion of the nondocumentary payment condition in a standby letter of credit creates a “borderland” payment obligation; the resulting credit contains terms that are characteristic of both a standby credit and a guaranty.

Nondocumentary payment conditions come in two forms; they may be either fundamental to or ancillary to the operation of the letter of credit.\textsuperscript{31} For example, if the nondocumentary payment condition in the hypothetical—the default of the applicant on its underlying performance obligation to construct the house by June 1—were drafted into a standby letter of credit, the nondocument-


\textsuperscript{30} See McLaughlin, supra note 8, at 37. On the entire issue of nondocumentary payment conditions, see ABA Task Force on the Study of U.C.C. Article 5, An Examination of U.C.C. Article 5 (Letters of Credit), 45 Bus. Law. 1521, 1546-61 (1990).

\textsuperscript{31} See Dolan, supra note 10, at 2-7 to -10.
tary condition would obviously be fundamental to the operation of the letter of credit. The main purpose of the letter of credit would be to protect the beneficiary against being damaged by the default of the applicant.

Other forms of nondocumentary payment conditions, however, could be ancillary to the purpose of the credit. For example, a commercial letter of credit may provide for the presentation of various shipping documents describing the goods and also require that the goods be shipped on a vessel that is not more than fifteen years old. This latter condition is nondocumentary in nature; to determine that the condition has been satisfied, the issuing bank would have to verify the actual age of the shipping vessel. This nondocumentary payment condition, however, is also ancillary to the central purpose of the credit, which is to pay for documents evidencing the shipment of specifically described merchandise.

The proposed draft of a revised Article 5 of the U.C.C. would handle each type of nondocumentary payment condition in a different way.

1. Ancillary Nondocumentary Payment Conditions

According to revised Article 5, a nondocumentary payment condition that is ancillary to the purpose of the letter of credit will not affect the nature of the instrument as a letter of credit. To protect payment of the standby credit from being dependent on the underlying transaction even to the smallest degree, the drafters of revised Article 5 have proposed that an ancillary nondocumentary payment condition (such as the age of the shipping vessel in the aforementioned hypothetical) should be disregarded. The issuing bank must pay the credit if and when all the documentary conditions are satisfied.

32. The example is taken from U.C.C. Revised Article 5 Letters of Credit § 5-110 cmt. 5 (Draft, Mar. 31, 1993).
33. See id. § 5-102 cmt. 6; id. § 5-110 cmt. 5.
34. Id. § 5-102 cmt. 6.
35. Id. § 5-110(d) & cmt. 5.
2. Fundamental Nondocumentary Payment Conditions

A nondocumentary payment condition that is fundamental to the purpose of a letter of credit, however, will be treated very differently under revised Article 5. According to the drafters of revised Article 5, such a nondocumentary payment condition will affect the nature of the instrument as a letter of credit.\(^{36}\) Though labeled as a letter of credit, the instrument will not be treated as a letter of credit under the law.\(^{37}\) Rather, according to the comments to revised Article 5, the resulting instrument will most likely be treated as a form of guaranty or other contractual arrangement.\(^{38}\)

One reason for treating such an instrument as something other than a letter of credit is the applicant-oriented nature of its fundamental term. To understand what this means, return for a moment to our original hypothetical in which the applicant agrees to construct a house for the beneficiary by June 1 or, failing that, to pay the beneficiary $50,000 in liquidated damages. The fundamental reason for Solid Gold Bank’s issuing a letter of credit was to protect the beneficiary/obligee against being damaged by the applicant/obligor’s default in the construction of the beneficiary’s house. Assume, however, that the letter of credit is drafted in such a way that before payment can be made to the beneficiary/obligee, Solid Gold Bank must determine whether the applicant/obligor did in fact default on its underlying obligation to construct the house by June 1. In making this determination, the applicant’s defenses become important to Solid Gold Bank because the bank is entitled to rely on them in justifying its refusal to pay.

Unless the applicant/obligor actually defaulted and was therefore required to pay $50,000 in liquidated damages, Solid Gold Bank need not pay. If the applicant/obligor has a defense excusing its failure to build the house by June 1, then there would be no default.\(^{39}\) The factual analysis relative to the question of default gives a full hearing to the applicant’s position on this central term prior to the bank’s honoring its letter-of-credit obligation.

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36. See id. § 5-110 cmt. 5.
37. See id. § 5-102 cmt. 6.
38. See id.
39. See infra notes 53-55 and accompanying text.
B. Standby Credits Issued Subject to the Uniform Rules on Demand Guarantees

In 1992, the International Chamber of Commerce issued the Uniform Rules for Demand Guarantees\textsuperscript{40} to cover independent demand guarantees, a type of instrument common in Europe.\textsuperscript{41} The definition of demand guarantee in the U.R.D.G., however, is broad enough to cover standby letters of credit.\textsuperscript{42} Although the drafters of the U.R.D.G. state that issuers of letters of credit should continue to issue their credits subject to the Uniform Customs and Practice for Documentary Credits\textsuperscript{43} (U.C.P.), the possibility still exists that an instrument labeled as a letter of credit may be issued subject to the U.R.D.G. The possibility also exists that a European bank may issue a letter of credit subject to the U.R.D.G. and then ask a U.S. bank to "confirm" such a credit under these rules.

If such a credit or confirmation were issued, it remains to be seen how a U.S. court would treat this "borderland" instrument. Article 17 of the U.R.D.G. would require the issuer of a standby credit subject to the U.R.D.G. to inform the applicant whenever a draw is made.\textsuperscript{44} No such duty currently exists either under the U.C.P. or under letter-of-credit law generally.\textsuperscript{45} The issuer's duty to notify the applicant of a draw makes a standby credit issued under the U.R.D.G. more applicant oriented than a comparable standby credit issued under the U.C.P. A rule requiring an issuer to give notice of a draw is intended to provide the applicant with adequate time to review the merits of the draw and, when appropriate, to seek to enjoin payment of the draw. Because the rule has the effect of reducing the certainty of payment represented by the

\textsuperscript{40} U.R.D.G. (1992).
\textsuperscript{42} See U.R.D.G. art. 2(a). See the Introduction to the U.R.D.G., in which the drafters admit that standby credits are "technically" within the definition of the U.R.D.G.'s "demand guarantee." \textit{Id.} at 4-5.
\textsuperscript{43} \textit{Id.} at 4.
\textsuperscript{44} Article 17 of the U.R.D.G. states in relevant part: "[I]n the event of a demand the Guarantor shall without delay so inform the Principal or where applicable its Instructing Party and in that case the Instructing Party shall so inform the Principal." U.R.D.G. art. 17. With respect to a standby letter of credit issued subject to the U.R.D.G., the issuing bank would be deemed the guarantor and the applicant would be deemed the principal.
standby letter of credit, it is in this sense more oriented in favor of
the applicant/obligor and therefore more akin to a rule of guaranty
law. Nevertheless, the willingness of U.S. courts in several letter-
of-credit cases to impose on issuing banks notice requirements may
bespeak a tolerant attitude towards this Article 17 requirement. If this is the case, the notice requirement imposed on issuing banks
under Article 17 may not affect the essential character of either the
U.R.D.G. credit or confirmation as a letter of credit.

C. “Quasi-Standby Letters of Credit”

As I noted earlier, a standby letter of credit is beneficiary ori-
ented as compared to a guaranty that—at least in its classic
form—is more applicant oriented. The independence principle, of
course, is the basis for the standby letter of credit's beneficiary or-
ientation. By weakening the independence principle, however,
courts often blur the distinction between standby credits and con-
tracts of guaranty. The main way in which courts weaken the inde-
 pendence of standby credits is through the application of proce-
dural and substantive rules to letters of credit that have the effect
of either allowing or encouraging an applicant/obligor to present
its case against payment before the beneficiary/obligee receives
payment. Under close scrutiny, the resulting payment instru-
ments are not clearly standby letters of credit or contracts of
 guaranty.

1. Procedural Rules

On occasion, courts have permitted issuing banks to resort to in-
terpleader when faced with a payment draw from a beneficiary and
an objection to payment from the applicant. Interpleader affords

46. See George Weisz & Jonathan I. Blackman, Standby Letters of Credit After Iran:
47. See, e.g., Banque Paribas v. Hamilton Indus., Int'l, 767 F.2d 380 (7th Cir. 1985) (de-
    monstrating one court's apparent indifference to the independence principle); Paccar Int'l,
    Inc. v. Commercial Bank, 587 F. Supp. 783 (C.D. Cal. 1984) (evidencing the predisposition
    of some courts to litigate in the credit controversy questions that arise out of related con-
    tracts), vacated, 757 F.2d 1058 (9th Cir. 1985) (reversing on appeal on a jurisdictional
    point).
48. See Algemene Bank Nederland N.V. v. Soysen Tarim Urunleri Dis Tiscaret Ve
the applicant for the credit the opportunity to present its case against honoring the credit before the proceeds of the credit are paid over to the beneficiary.\textsuperscript{49} A declaratory judgment action brought by the issuing bank prior to paying its credit has an effect similar to an interpleader action,\textsuperscript{50} in that payment to the beneficiary is delayed until the applicant has a hearing on its arguments against paying the beneficiary. The effect of interpleader and declaratory judgment actions is therefore to turn the standby letter of credit into a payment instrument that resembles, at least in part, a guaranty. Just as the principal obligor's case against paying a guaranty will be fully reviewed before a guarantor will honor its guaranty, so too will the applicant/obligor's case be reviewed before a letter of credit is paid.

Not all general rules of procedure, however, are as harmful to the independence of the standby letter of credit as interpleader and declaratory judgment actions. So-called "notice injunctions"—injunctions that require the issuing bank to give the applicant advance notice before a letter of credit is paid\textsuperscript{51}—do not per se allow the applicant to present its case against payment before the issuing bank honors its credit.\textsuperscript{52} Nonetheless, "notice injunctions" harm the standby credit by giving the applicant/obligor time to consider whether or not to enjoin payment of the letter of credit.

2. \textit{Substantive Rules}

A guarantor can utilize most of its principal's defenses to payment in determining whether it is obligated to honor its guaranty.\textsuperscript{53} This, of course, is not the case with an issuer of a standby letter of credit. In most circumstances, section 5-114(2) of the U.C.C. allows an issuing bank to refuse to honor (or be enjoined

\begin{footnotes}
\textsuperscript{49} See Dolan, supra note 10, at 3-26.
\textsuperscript{51} See Weisz & Blackman, supra note 46, at 356 n.6.
\textsuperscript{52} See Dolan, supra note 10, at 7-77 to -79.
\textsuperscript{53} See Restatement of Security §§ 117-118, 126 (1941).
\end{footnotes}
from honoring) its letter of credit only if the beneficiary has perpetrated fraud in Contract I (the underlying contract). Absent fraud in Contract I, however, the issuing bank cannot utilize any of its applicant/obligor's Contract I defenses in determining whether to pay on its letter of credit. Not being able to rely on applicant defenses, of course, is fundamental to the independence principle of letter-of-credit law.

Courts and commentators, however, have occasionally suggested that an issuing bank can utilize Contract I defenses in addition to the beneficiary's fraud to justify its refusal to honor its letter-of-credit obligation. These decisions, of course, weaken the independence principle and blur the borders separating the standby letter of credit from the contract of guaranty.

The case of Ross Bicycles, Inc. v. Citibank, N.A., is a recent example of a court's acknowledging that, in appropriate circumstances, it would have permitted a Contract I defense other than the beneficiary's fraud to affect payment of a letter of credit. In Ross Bicycles, Citibank issued a one million dollar letter of credit in favor of beneficiary Ross Bicycles for the account of Wedtech Corporation. After Wedtech filed for bankruptcy, Ross Bicycles drew under the credit. Citibank interposed various defenses to Ross Bicycles' draw. One of Citibank's main defenses was the alleged illegality of the underlying Ross Bicycles-Wedtech contract.

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54. See U.C.C. § 5-114(2)(b) (1990); id. § 5-114 cmt. 2. The fraud in U.C.C. § 5-114(2) refers to fraud in Contract I. See Rockwell Int'l Systems, Inc. v. Citibank, N.A., 719 F.2d 583, 589 (2d Cir. 1983). But see FDIC v. Bank of San Francisco, 817 F.2d 1395, 1399-1400 (9th Cir. 1987) (holding that an issuer of a letter of credit was not authorized to dishonor a draft for fraud outside documents required by the letter of credit).
56. 577 N.Y.S.2d 827.
57. Id. at 826-29.
58. Id. at 827.
59. Id.
60. Id.
61. Id.
The New York Appellate Division, however, was not persuaded by Citibank's illegality defense, citing three reasons. First, according to the court, Citibank offered only "conclusory allegations" with respect to the possible illegality of Ross Bicycles' dealings with Wedtech. Second, under New York law, for Citibank's illegality defense to be valid, the alleged illegality would have to be "‘central to or a dominant part of the plaintiff’s whole course of conduct in performance of the contract’" but Citibank submitted no evidence that Ross Bicycles' conduct met this requirement. Third, Citibank was a "third party" in the sense that it was simply holding the property of one of the parties who might be participating in some illegality without itself being engaged in that illegality and as such was not entitled to use the defense.

Although the court did not permit the alleged Contract I illegality to affect payment of the letter of credit in this particular case, it did suggest that the defense would have been valid if the allegations of illegality had not been conclusory and the alleged illegality had been "‘central to or a dominant part of the plaintiff’s whole course of conduct in performance of the contract.’" Inferentially, the court in Ross Bicycles seems to have recognized a new exception to the independence principle and a new defense available to issuing banks who wish to dishonor their credits. Although recognizing Contract I illegality as an exception to the independence principle seems to be a correct result, it does further confuse the distinction between a letter of credit and a guaranty. It creates yet another breach in the wall that is supposed to keep Contract I defenses separate from, and independent of, Contract III.

62. Id. at 828.
63. Id. (citing McConnell v. Commonwealth Pictures Corp., 166 N.E.2d 494, 497-98 (N.Y. Ct. App. 1960)).
64. Id.
65. Id. (citing McConnell, 166 N.E.2d at 497-98).
66. It would have been helpful if the New York appellate court had provided clearer guidance on the issue of illegality in the underlying contract as a defense to payment of a letter of credit. One fruitful path of analysis might have been to consider in this context the old common law distinction between acts that are *mala prohibita* (illegal because prohibited) and those that are *mala in se* (illegal because intrinsically harmful to society).
III. IN DEFENSE OF DYNAMIC BORDERS

It seems to this author at least that rigid borders between standby letters of credit and contracts of guaranty are not necessarily a good thing. In the political arena, barbed-wire fences and mine fields limit healthy intercourse between nations. Similarly, in the legal arena, a too-rigid insistence on symmetry—an “all or nothing” approach with respect to the rules applicable to standby credits or guaranties—will limit healthy interaction between the two. One of the underlying policies of commercial law is to permit the continued expansion of business practices through agreement of the parties. Giving the parties in the marketplace the choice of drafting financial instruments that are either slightly less beneficiary oriented than the classic standby letter of credit, or slightly less applicant oriented than the classic contract of guaranty, is clearly a desirable policy goal. Generally speaking, this goal has been achieved in guaranty law. In the text of the guaranty, a guarantor can waive reliance on all of the principal obligor’s defenses without changing the nature of the obligation as a guaranty. The same, however, cannot be said about letter-of-credit law.

The issue of subrogation crystallizes the point being made here. The majority view is that the independence principle of letter-of-credit law prohibits applying the doctrine of subrogation in letter-of-credit cases. For example, an issuing bank that pays a beneficiary under a letter of credit (Contract III) will not be allowed to be subrogated to the Contract I rights of the beneficiary against the applicant. For subrogation to be permitted, the bank would have had to issue a guaranty instead of a letter of credit.

A rule allowing subrogation is clearly accepted in guaranty law and, except for an “all or nothing” approach with respect to letters of credit, it makes sense to accept this rule in letter-of-credit transactions as well. Once the issuing bank honors its letter-of-

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67. DEMKO, supra note 1, at 99.
70. See Kaiser Steel, 89 B.R. at 152-54.
71. See id.
credit obligation, the policies supporting the independence principle are satisfied; Contract III (the letter of credit) has been kept separate from Contract I (the underlying contract). There is no longer a reason to adhere to a rule that has served its purpose and is no longer relevant. This argument seems stronger still when we realize that the doctrine of subrogation can be worked into a letter-of-credit transaction through a documentary payment condition; that is, as a condition of payment, the beneficiary can be required to provide the issuing bank with a written assignment of its Contract I rights against the applicant.

If the courts were to allow subrogation in letter-of-credit cases, it would not necessarily follow that all other “guaranty” rules must also be applied wholesale to letters of credit. There is room for some picking and choosing consistent with the dominant purpose of the basic payment mechanism—beneficiary orientation in the case of a standby credit and applicant orientation in the case of a contract of guaranty. Dynamic borders will allow for some jutting excrescences.