

# Louisiana Law Review

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Volume 45 | Number 4  
*March 1985*

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## Letter of Credit: Gold Bullion?

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### Repository Citation

Laura K. Austin, *Letter of Credit: Gold Bullion?*, 45 La. L. Rev. (1985)  
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## NOTES

### LETTER OF CREDIT: GOLD BULLION?\*

#### *Introduction*

Letters of credit<sup>1</sup> are a type of commercial paper traditionally used to provide prompt payment for goods shipped long distances. Increasingly, the letter of credit is being used as a security device in commercial transactions rather than as a primary source of payment. This latter type of credit, known as a standby or guaranty letter of credit, is payable upon the customer's default on a financial or other obligation.<sup>2</sup>

The commercial utility of the letter of credit is twofold: first, the credit of a bank is substituted for the customer's credit and second, the letter of credit creates an obligation to pay that is independent of any contractual defenses the customer may have in the primary or "underlying" transaction. The second of these features, the so-called "independence principle," allows the seller to obtain payment even if he has breached his contractual obligations so seriously that no payment should be due under the primary contract. Payment is enjoined only when the beneficiary fails to produce the required documents or where one or more of these documents is not genuine. Whether a beneficiary should be paid merely on presentation of documents, even where he has committed actual fraud in the underlying transaction, is the subject of this comment.

A recent Louisiana Supreme Court decision provides a good example of the competing equities between the independence principle and the commercial expectation of honesty. The supreme court in *Cromwell v. Commerce & Energy Bank*<sup>3</sup> announced the circumstances under which payment of a letter of credit could be enjoined pursuant to Louisiana Revised Statutes 10:5-114(2)(b).<sup>4</sup> The court, interpreting that statute for

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\* The writer was previously employed by the firm of Durio, McGoffin, Andrus & Stagg, attorneys for the plaintiffs in *Cromwell v. Commerce & Energy Bank*, 464 So. 2d 721 (La. 1985).

1. "Credit" or "letter of credit" means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Chapter that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.

La. Commercial Laws: La. R.S. 10:5-103(a) (1983) [hereinafter cited as La. Com. Laws].

2. See generally J. White & R. Summers, *Handbook of the Law Under the Uniform Commercial Code* 709 (2d ed. 1980).

3. 464 So. 2d 721 (La. 1985).

4. Unless otherwise agreed, when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform

the first time in Louisiana, held that, where the seller and beneficiary were guilty of fraud in the underlying transaction this fraud would justify an injunction of a standby letter of credit.<sup>5</sup> This *res nova* decision is important at both the state and national levels. *Cromwell* will set the standard for interpreting letter of credit transactions in Louisiana, and since Louisiana Revised Statutes 10:5-114 is identical to the Uniform Commercial Code Section 5-114, the case will provide recent authority on an infrequently interpreted portion of the latter statute. Two aspects of the *Cromwell* opinion will be examined in this comment: first, under what circumstances payment of the letter of credit should be enjoined due to fraud in the underlying transaction and second, whether an assignee of the beneficiary should be subject to the defense of fraud in the underlying transaction. Before analyzing the issues which were considered by the Louisiana courts, some background information on the mechanics of letters of credit will be helpful.

### *The Mechanics of a Letter of Credit Transaction*

Basically, a traditional or documentary letter of credit transaction encompasses three separate transactions. In the first, or underlying transaction, between a buyer and seller, the seller provides merchandise for a given price. The second transaction is between the buyer and the issuer of the letter, typically a bank or other lending institution, in which the bank issues a letter of credit to the seller-beneficiary in exchange for the buyer's payment of a fee.<sup>6</sup> Finally, the letter of credit itself creates a relationship between the issuer and the beneficiary.<sup>7</sup>

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to the warranties made on negotiation or transfer of a document of title [Section 7-507] or of a security [Section 8-306] or is forged or fraudulent or there is fraud in the transaction

(a) The issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder if the draft or demand which would make it a holder in due course [Section 3-302] and in an appropriate case would make it a person to whom a document of title had been duly negotiated [Section 7-502] or a bona fide purchaser of a security [Section 8-302]; and

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the document, but a court of appropriate jurisdiction may enjoin such honor.

La. Com. Laws § 10:5-114(2).

5. 464 So. 2d at 734. For a more detailed explanation of the supreme court's characterization of the transaction see *infra* text accompanying notes 42-44.

6. See J. White & R. Summers, *supra* note 2, at 704-15.

7. *Id.*; B. Clark, *The Law of Bank Deposits, Collections and Credit Cards* 8-6 (1981); but see *Baker v. National Blvd. Bank*, 399 F. Supp. 1021, 1024 (N.D. Ill. 1975) (issuer-beneficiary relationship characterized as an "agreement").

However, once the letter of credit is established, the issuer becomes statutorily obligated to pay drafts drawn under the letter of credit upon the beneficiary's presentation of the required documents.<sup>8</sup> Merchants developed the letter of credit to provide a prompt and certain method of payment for goods shipped in international trade.<sup>9</sup> The documentary letter of credit was developed as an alternative to the documentary sale.<sup>10</sup>

A typical documentary letter-of-credit transaction might involve the following events: United States customer *A* desires to purchase a shipment of wine from French seller *B*. *B*, desiring prompt payment and unsure of *A*'s creditworthiness, requires *A* either to pay cash in advance of shipment or to establish a letter of credit. *A*, not willing to pay for the wine until he knows it has been shipped, opts for payment by a letter of credit. *A* goes to his bank and asks it to issue a letter of credit for *B*'s benefit, to be paid upon presentation of a bill of lading. A bill of lading can only be obtained by delivery of the wine to a shipper and consigning it as the seller requires. Upon shipment of the wine, *B* or a collecting bank presents a draft<sup>11</sup> drawn under the letter of credit and the bill of lading to the issuing bank for payment. The issuing bank pays *B* and subsequently collects the amount paid from *A*.<sup>12</sup>

Such a transaction has a high degree of commercial utility, stemming from the fact that the bank rather than the buyer is primarily liable to the seller. Substitution of a bank as the primary debtor decreases the risk of nonpayment due to insolvency. Furthermore, the relationship between the bank and the seller is generally independent of the underlying contract between the buyer and seller. The independence of the credit reduces the risk of nonpayment due to the buyer's asserting defenses to payment such as breach of warranty.<sup>13</sup> From the buyer's perspective, however, the independence of the letter of credit creates a risk that the issuer may honor a draft when the beneficiary has fraudulently failed to perform his obligations. A carefully drafted letter of credit provides

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8. J. White & R. Summers, *supra* note 2, at 711.

9. Harfield, *Code Treatment of Letters of Credit*, 48 *Cornell L.Q.* 92, 93 (1962).

10. In a documentary sale, the buyer and seller agree that payment will be made upon the seller's presentation of certain documents, usually a bill of lading and a sight draft. After the goods are shipped, the seller or his agent will present the documents to the buyer, who is obligated to make immediate payment. Risk of the buyer's insolvency, dishonesty, or nonpayment due to a bona fide dispute are inherent in such a transaction. See J. White & R. Summers, *supra* note 2, at 705-06.

11. A draft is a written order to pay a sum certain in money, payable on demand or at a definite time and payable to order or bearer. Uniform Commercial Code 3-104; La. Com. Laws § 10:3-104.

12. See J. White & R. Summers, *supra* note 2, at 704-08.

13. *Id.* at 706-07.

substantial protection to the buyer. He can require invoices, bills of lading, or inspection certificates to insure that the beneficiary has in fact complied with his obligations.

The standby letter of credit operates in the same basic framework as the documentary credit.<sup>14</sup> The main difference is that the standby letter of credit is used not as the expected means of payment, but rather to secure payment. This is reflected in the type of documentation generally required by the standby letter of credit. In a documentary credit, the key documents are usually a bill of lading and an invoice. In a standby letter the key document is a "certificate of default," often simply a statement that the beneficiary is alleging a default and demands payment under the letter.<sup>15</sup>

In both the documentary and standby letters of credit, the relationship between the issuer and the seller-beneficiary is independent of the underlying transaction. However, in the standby transaction, where simple demand is the only document required for payment, the documents do not protect the customer as they do in the typical documentary transaction.<sup>16</sup> Therefore, the protection against fraudulent documents does little for the standby customer who is not really looking to the documents for protection.<sup>17</sup> Thus, the question of whether the courts will enjoin payment only for documentary fraud or also for fraud in the underlying contract becomes critical for the standby customer.

Section 5-114 of the Uniform Commercial Code codifies the rule of an early pre-code case<sup>18</sup> that allowed courts to enjoin payment of a letter of credit when fraud occurred in the underlying transaction.<sup>19</sup> However, in order to preserve the commercial vitality of the letter of credit, the exceptions to the independence principle generally have been narrowly construed.<sup>20</sup> Reconciling these two competing principles—pre-

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14. See B. Clark, *supra* note 7, at 8-5. U.C.C. Article 5 does not distinguish between documentary and standby letters of credit and has been interpreted as applying equally to both types of credits. See, e.g., *Pringle-Associated Mortgage Corp. v. Southern Nat'l. Bank*, 571 F.2d 871, 874 (5th Cir. 1978).

15. J. White & R. Summers, *supra* note 2, at 713-14; B. Clark, *supra* note 7, at 8-5.

16. Comment, "Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution, 93 *Harv. L. Rev.* 992, 1011-12 (1980).

17. See *id.* at 1012. The documents in a standby letter reflect the beneficiary's perception of the customer's default. See *id.* at 1012 n.92. Documentary fraud in such a situation would probably be extremely difficult to prove.

18. *Sztejn v. J. Henry Schroder Banking Corp.*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

19. *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 41 N.Y.2d 254, 259, 360 N.E.2d 943, 948, 392 N.Y.S.2d 265, 270 (1976); Comment, *supra* note 16, at 1002.

20. J. White & R. Summers, *supra* note 2, at 735. For an example of strict application of § 5-114, see *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 336 A.2d 316 (1975); but see Comment, *supra* note 16, at 1003-04.

servicing the commercial utility of the letter of credit and discouraging fraud—is not an easy task. On one hand, the inclination is to require the issuer to pay under the credit, despite the allegations of fraud, so that commerce will not be disrupted.<sup>21</sup> Conversely, a “clean hands” analysis would prevent a dishonest beneficiary from profiting at the expense of an innocent buyer.<sup>22</sup>

This writer feels that the standby customer should be protected from fraud in the underlying transaction even at the expense of some of the certainty of payment that gives the letter of credit its utility. The narrow interpretation of the exceptions to the independence principle has resulted in letters of credit being treated more as currency or gold bullion—having intrinsic value—rather than as a commercial instrument, subject to certain statutorily created defenses. Such treatment is not desirable from a policy standpoint. The letter of credit that is based on fraud should not be a viable commercial instrument. Even if treating letters of credit as “currency” was theoretically a desirable policy, such treatment is contrary to the policy decision which has already been made by the drafters of the Uniform Commercial Code. Section 5-114 was deliberately chosen to provide protection for the customer. This comment suggests that such a policy decision is correct.

#### *Analysis of Cromwell v. Commerce & Energy Bank*

The litigation in *Cromwell* arose when European American Bank of New York (EAB) attempted to draw drafts under letters of credit that had been transferred<sup>23</sup> as security for a loan made to Combined Investments, Ltd. (CI), a Louisiana partnership *in commendam* formed on September 23, 1981 as a blind-pool real estate venture.<sup>24</sup> Combined Equities, Inc. (CE), a Baton Rouge-based tax-shelter promoter, served as the general partner. Several Louisiana banks issued the letters of credit at the direction of the investors in Combined Investments, each of whom was required as part of the price for investing, to provide a demand note secured by a letter of credit. Combined Investments defaulted on the EAB loan in September 1982. Beginning on November

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21. See Harfield, *Enjoining Letter of Credit Transactions*, 95 *Banking L.J.* 596 (1978) (an article taking a strong anti-injunction stand).

22. See 177 *Misc.* at 722, 31 *N.Y.S.2d* at 634; *Cromwell v. Commerce & Energy Bank*, No. 82-6413-H, *Reasons for Judgment* (15th La. Jud. Dist. Ct. Feb. 10, 1983).

23. The trial court found that the letters of credit had been assigned to EAB. *Cromwell*, No. 82-6413-14. The supreme court reversed that factual finding. *Cromwell*, 464 *So. 2d* at 736. For a discussion of the effect of that reversal, see *infra* text accompanying notes 108-23.

24. A blind-pool real estate offering is one in which no property is owned or specifically designated as a potential investment at the time the units are sold. 464 *So. 2d* at 723.

24, 1982, EAB drew drafts on the investors' letters of credit. The investors' allegations of fraud led to the issuance of temporary restraining orders which prevented the issuing banks from honoring EAB's drafts.<sup>25</sup>

The trial court granted a preliminary injunction based on its finding that "there was substantial fraud in the underlying transaction by Combined Equities, Inc."<sup>26</sup> The court, relying on Louisiana Civil Code article 1847,<sup>27</sup> found that Combined Equities made oral and written misrepresentations in connection with the transactions, including misrepresentations concerning the investment objectives of Combined Investments.<sup>28</sup> In the trial court's view, the underlying transaction was Combined Investment's sale of its limited partnership interests in consideration of the letters of credit and the other payments from the investors.

The trial judge noted that the independence of the letter of credit obligations from the defenses associated with the underlying transaction was vital to the commercial utility of letters of credit. The trial court opinion saw the tension between the commercial utility of the letters and the "commercial expectation of honesty"<sup>29</sup> and concluded that the "independence theory must not be allowed to protect a letter of credit transaction that is based upon fraud."<sup>30</sup>

The trial court perceived that EAB was a transferee of Combined Investments, the beneficiary of the letters of credit.<sup>31</sup> Despite its recognition that letters of credit were non-negotiable, the lower court stated that it would permit the independence principle to protect EAB if it could prove that it took the letter of credit under circumstances which would make it a holder in due course.<sup>32</sup> Based upon extensive testimony, however, the court found that EAB was not entitled to be treated as

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25. In addition to state court litigation on the letters of credit, EAB filed suit in federal court to collect on the promissory notes. *European American Bank v. Combined Investments, Ltd.*, No. 83-0255-B (M.D. La. 1983).

26. *Cromwell*, No. 82-6413-H, minute entry (15th La. Jud. Dist. Ct. Feb. 10, 1983).

27. "Fraud, as applied to contracts, is the cause of an error bearing on a material part of the contract, created or continued by artifice, with design to obtain some unjust advantages to the one party, or to cause an inconvenience or loss to the other." La. Civ. Code art. 1847.

28. The trial judge found that the limited partners were led to believe that the investment objectives of Combined Investments were to invest directly in real estate. Instead, Combined Equities used the investors' capital contributions and loan proceeds to lend money to its affiliates and to pay fees to itself, as general partner, and to other affiliates. See *Cromwell*, No. 82-6413-H, Reasons for Judgment (15th La. Jud. Dist. Ct. Feb. 10, 1983).

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

a holder in due course because it was in bad faith and had notice of the fraud practiced by Combined Equities on the investors.<sup>33</sup>

The third circuit did not disturb the factual findings of the lower court, with one exception discussed below, but reversed the decision based on the interpretation of "fraud in the transaction."<sup>34</sup> According to the appellate court, the "independence of the letter of credit from other contracts, arrangements and relationships involved in the underlying transaction, out of which the letter of credit arises, is the cornerstone of its utility."<sup>35</sup>

The appellate court's decision was based largely upon its characterization of the structure of the standby letter of credit transaction. The court stated that in the standby letter of credit there were four parties—the same parties who were found in the documentary letter of credit plus a lending bank who loans money to the seller to finance the underlying transaction.<sup>36</sup> Thus, the court found that the ordinarily dual role of the seller-beneficiary was divided into two separate roles—the seller and the lending bank-beneficiary.<sup>37</sup> The court concluded that EAB, the lending bank-beneficiary, was a fourth party not involved in the fraud committed by Combined Equities.

The court did not reach the assignment issue because it seemed not to understand that the letters of credit had originally been issued not to EAB but to Combined Investments. The trial court found, and the record adequately supports a finding, that Combined Investments, not EAB, was a beneficiary of the letters of credit. The letters were assigned or transferred to EAB,<sup>38</sup> but did not name it as the beneficiary. The third circuit inexplicably chose to disregard the lower court's findings. The Louisiana Supreme Court held that if EAB was guilty of fraud with respect to the investors or knew of the fraud committed by CE or CI that an injunction should issue.<sup>39</sup> The supreme court found that EAB was not guilty of any fraud and had no notice of any fraud and

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33. *Id.* The trial court found EAB in bad faith because of its knowledge of the unstable financial condition of the general partner. The court also concluded that EAB had knowledge of the written misrepresentations made by Combined Equities in the Private Placement Memorandum.

34. *Cromwell v. Commerce & Energy Bank*, 450 So. 2d 1, 9 (La. App. 3d Cir. 1984).

35. *Id.* at 12.

36. *Id.* at 7.

37. *Id.*

38. *Cromwell*, No. 82-6413-H, Reasons for Judgment (15th La. Jud. Dist. Ct. Feb. 10, 1983). See *infra* at fn. 102-123 and text accompanying for a discussion of the assignment of the letters of credit and whether an assignee-beneficiary should be subject to the customer's defense of fraud in the underlying transaction.

39. 464 So. 2d at 734.



therefore affirmed the third circuit's denial of a preliminary injunction.<sup>40</sup> However, because the parties did not stipulate that the court's decision on the preliminary injunction would preclude a trial on the merits the case was remanded to the trial court for a trial on the permanent injunction.<sup>41</sup>

The supreme court characterized the letter of credit transaction differently from both the trial court and third circuit. The court viewed the transaction as including three parties: EAB, as the "final beneficiary,"<sup>42</sup> CI, and the issuing banks.<sup>43</sup> The loan transaction between EAB and CI was the underlying transaction, *i.e.*, the transaction that if fraudulent would support an injunction. The transaction between the investors and CI and CE was apparently regarded as a subsidiary transaction which should be looked to in determining fraud in the underlying transaction.<sup>44</sup>

### *Fraud in the Transaction*

The Louisiana Supreme Court reversed the third circuit's holding that "fraud in the transaction"<sup>45</sup> does not include fraud in the underlying transaction.<sup>46</sup> The decision is an important one, because there are relatively few cases reaching such a result. This writer submits that this result was correct in light of the legislative history of Section 5-114 and the prior jurisprudence.

40. *Id.* at 736.

41. *Id.* at 737.

42. 464 So. 2d at 723.

43. *Id.* at 722.

44. The transaction could be diagrammed as follows:

EAB (beneficiary

CI

Investors

issuing banks

The relationship between the issuing banks and CI is unclear. The supreme court apparently adopted the traditional view that a letter of credit involves only three parties. Thus, the third circuit's characterization of the transaction as involving four parties seems to be overruled. See discussion *infra* at 21. In contrast to the preceding diagram, the third circuit would probably picture the transaction as follows:

EAB

investors

CI

issuing banks

45. U.C.C. § 5-114.

46. Despite the court's failure to find fraud in the instant case, the statement that fraud exists in the underlying transaction is not mere *dicta*. The trial court must grant an injunction, if after trial on the merits, it finds EAB was a party to or had knowledge of the fraud.

*Early Jurisprudence*

The seminal decision involving fraud in the underlying transaction is *Sztejn v. J. Henry Schroder Banking Corp.*<sup>47</sup> *Sztejn* contracted to buy a shipment of bristles from an overseas merchant and furnished a letter of credit as payment for the goods. The seller shipped cow hair and other worthless rubbish instead and subsequently presented drafts drawn under the letter of credit for payment. The court heard the case on a motion to dismiss and thus accepted as true the plaintiff's allegations that the seller "intentionally failed"<sup>48</sup> to ship the correct merchandise and that the "primary transaction was tainted with fraud."<sup>49</sup> The court was concerned with preserving the commercial utility of letters of credit, but denied the defendant's motion to dismiss, stating that "the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller."<sup>50</sup> The *Sztejn* court never used the words "underlying transaction" as being the source of the fraud. However, the court's language indicates that the buyer-seller transaction was the source of the fraud. Reference to the seller's intentional failure to ship conforming merchandise and to the distinction between active fraud and mere breach of warranty supports this view.<sup>51</sup>

The third circuit cited *Sztejn* as supporting an injunction in cases where "the beneficiary-seller committed active fraud rendering the documents fraudulent."<sup>52</sup> The supreme court opinion perpetuated this view. The court discussed the holding in *Sztejn* and noted it had been applied in *Shaffer v. Brooklyn Park Garden Apartments*,<sup>53</sup> a case involving fraudulent documents.<sup>54</sup>

Fraud in the transaction is often mislabeled as fraud in the documents.<sup>55</sup> The theory for such an analysis is that documents which represent that conforming merchandise had been shipped, when in fact the seller has fraudulently failed to do so, are themselves fraudulent.<sup>56</sup> Technically, only documents that were initially genuine and later altered

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47. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

48. Id. at 722, 31 N.Y.S.2d at 634.

49. Id. at 723, 31 N.Y.S.2d at 635.

50. Id. at 722, 31 N.Y.S.2d at 634.

51. Id. at 722-23, 31 N.Y.S.2d at 634-35.

52. *Cromwell*, 450 So. 2d at 11. For similar views of *Sztejn*, see also Harfield, *supra* note 21, at 601-05; Note, Letters of Credit: Injunction As A Remedy For Fraud in U.C.C. Section 5-114, 63 Minn. L. Rev. 487, 501 (1979).

53. 311 Minn. 452, 250 N.W.2d 172 (1977).

54. 464 So. 2d at 731.

55. Comment, *supra* note 16, at 1006-07. See B. Clark, *supra* note 7, at 8-55 to 8-57, for an analysis of cases decided on the basis of fraudulent documents, when actually the fraud occurred in the transaction.

56. Comment, *supra* note 16, at 1007.

can be considered fraudulent.<sup>57</sup> Thus, the real source of the fraud, and therefore the correct focal point in *Sztejn* and similar cases, is the underlying transaction.<sup>58</sup> It is particularly important to recognize the true source of the fraud when applying the reasoning in documentary letter of credit cases to standby letter of credit cases, because in a standby case there are few, if any, documents, and thus documentary fraud is rare. Incorrectly reasoned documentary letter of credit cases fail to provide the precedent for enjoining payment in the underlying transaction in a standby letter of credit. Despite the above argument that *Sztejn* stands only for the proposition that an injunction should issue due to fraudulent documents, the vast majority of cases and commentaries reviewing the decision have cited it as supporting an injunction due to fraud in the underlying transaction.<sup>59</sup>

#### *The Uniform Commercial Code—Early Drafts and Comments*

The redactors of the Uniform Commercial Code intended to codify the *Sztejn* holding in Section 5-114.<sup>60</sup> The early drafts and comments to the U.C.C. demonstrate that the drafters intended the phrase "fraud in the transaction" to cover many circumstances.<sup>61</sup> For example, the 1950 American Law Institute draft of the Uniform Commercial Code contained an early version of Section 5-114. Under that section<sup>62</sup> an issuing bank was excused from honoring a draft by "forgery or fraud in any required document of title or to the insurance and was also excused as against a seller or other consignor by non-conformity of the goods so severe that it amounted to fraud."<sup>63</sup> The comments to that section reiterate the principle set out in *Sztejn*: the beneficiary's good faith is the key to the commercial utility of the credits.<sup>64</sup> The 1951 draft of the U.C.C. incorporated Section 5-120 into Section 5-111, with only minor changes in the language. Section 5-111 provided that an issuing bank, unless enjoined, could honor a letter of credit "whether or not

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57. *Id.*

58. See *id.* at 1007-08; B. Clark, *supra* note 7, at 8-55 to 8-57.

59. See, e.g., J. White & R. Summers, *supra* note 2, at 736.

60. *United Bank*, 41 N.Y.2d at 259, 360 N.E.2d at 948, 392 N.Y.S.2d at 270.

61. *Id.* at 260, 360 N.E.2d at 949, 392 N.Y.S.2d at 271.

62. U.C.C. § 5-120 (Proposed Final Draft 1950).

63. *Id.*

64.

Essential good faith is again the key to the final provision of this section.

Where a non-conformity in the goods is such as to demonstrate fraud, the general purpose of the institution must yield to proof, if it can be had, of the beneficiary's bad faith in the particular case.

*Id.* § 5-120, comments.

... notified of a forgery or fraud or an alleged forgery or fraud in a document apparently regular on its face."<sup>65</sup>

The language of Section 5-111 indicates that the drafters contemplated some type of fraud other than fraud in the documents. The general phraseology of the statute, particularly given the language of Section 5-120, its immediate predecessor, supports the conclusion that the redactors intended any type of fraud in a letter of credit transaction to support an injunction. If the drafters had intended to change the portion of Section 5-120 that allowed an injunction for fraudulently nonconforming goods, surely Section 5-111 would have been phrased more restrictively. Section 5-111 was codified with no substantive change in Section 5-114.<sup>66</sup> As one commentator has noted:

[T]he legislative history of section 5-114(2) indicates that "fraud in the transaction" was meant to embody an exception to the independence principle and provide for injunctive relief based solely on the beneficiary's misperformance of the underlying contract.<sup>67</sup>

### *Subsequent Cases*

Relatively few cases have arisen under Section 5-114(2)(b) since the adoption of the Uniform Commercial Code nearly 30 years ago. Several courts have granted injunctions based on fraud in the underlying transaction. Other cases have taken the contrary view—that fraud in the underlying transaction will not support an injunction. Significantly, none of the latter cases found fraud in the underlying transaction.

Courts have granted injunctions in nonconforming merchandise cases similar to *Sztejn*. In *United Bank Ltd. v. Cambridge Sporting Goods Corp.*,<sup>68</sup> the seller sent used, torn, and mildewed boxing gloves instead of the new gloves the customer had ordered. The court found that the drafters of Section 5-114 intended the phrase "fraud in the transaction" to be flexibly applied to the circumstances of the individual case.<sup>69</sup> The court recognized the difficulty of drawing a line between a mere breach of warranty and fraudulent practices on the part of the seller.<sup>70</sup> However, the court found that the plaintiff had proven that the defendant was

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65. U.C.C. § 5-111 (National Conference of Commissioners on Uniform State Laws Sept. 3, 1951).

66. U.C.C. § 5-114 (National Conference of Commissioners on Uniform State Laws, Recommendations of the Editorial Bd. 1956).

67. Comment, *supra* note 16, at 1004 (footnote omitted).

68. 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976).

69. *Id.* at 260, 360 N.E.2d at 949, 392 N.Y.S.2d at 271.

70. *Id.* at 260-61, 360 N.E.2d at 949, 392 N.Y.S.2d at 271.

“guilty of *fraud* in shipping, not merely nonconforming merchandise, but worthless fragments of boxing gloves.”<sup>71</sup> Any ambiguities created by the *Sztejn* opinion as to whether an injunction under Section 5-114 would issue only for fraudulent documents seems to have been resolved in *United Bank*. The focus was on the fraud committed in the underlying sales contract, rather than on fraudulent documents.

In *NMC Enterprises, Inc. v. CBS*,<sup>72</sup> a wholesaler of audio equipment contracted to buy four different models of stereo receivers from the defendant, CBS. The receivers did not conform to the technical specifications in the sales brochures. The plaintiff introduced evidence that CBS was aware of the defects in the equipment and marketed them anyway. The court noted that generally a letter of credit is independent of the underlying sales contract but concluded that “where no innocent third parties are involved and where the documents or the underlying transaction are tainted with fraud, the draft need not be honored.”<sup>73</sup> The focus of the court in *NMC*, as in *United Bank*, is clearly on the fraud which existed in the underlying sales transaction.

In *Banco Espanol de Credito v. State Street Bank & Trust Co.*,<sup>74</sup> the seller’s misrepresentation that certain samples had been inspected resulted in the trial court’s finding of fraud in the underlying transaction. That finding was not challenged on appeal. However, the appellate court found the plaintiff to be a holder in due course and thus, relying on Section 5-114(2)(a), granted no injunction.<sup>75</sup> In prior litigation, the Appellate Court reversed the trial court’s finding that the documents, in this case an inspection certificate, were fraudulent.<sup>76</sup> Thus, as in the cases discussed above, the court’s decision was based on fraud in the underlying transaction, rather than on documentary fraud.

The courts have been equally willing to grant an injunction in standby letter of credit transactions. Allegations of fraud in procuring letters of credit and fraud in the performance of the underlying transaction were sufficient to defeat a collecting bank’s motion for an accelerated judgment in *Banco Tornquist v. American Bank & Trust Co.*<sup>77</sup> In that case, the plaintiff-beneficiary was given a standby letter of credit to secure payment of the debts of various Argentinian corporations. The court did not elaborate on the basis for the allegations of fraud in procuring the letter of credit, but did note charges of fraudulent depletion of the

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71. *Id.* at 261, 360 N.E.2d at 949, 392 N.Y.S.2d at 271.

72. 14 U.C.C. Rep. Serv. 1427 (N.Y. Sup. Ct. 1974).

73. *Id.* at 1429.

74. 409 F.2d 711 (1st Cir. 1969).

75. *Id.* at 713-14.

76. *Id.* at 712.

77. 71 Misc. 2d 874, 337 N.Y.S.2d 489 (Sup. Ct. 1972).

assets of the debtor companies. The court, relying on *Sztejn*, denied the plaintiff's motion for accelerated judgment.<sup>78</sup>

The Eight Circuit in *Bank of Newport v. First National Bank*<sup>79</sup> held that an issuing bank properly dishonored a draft drawn under a standby letter of credit. The facts in that case were similar to those in *Cromwell*. A group of doctors contracted to buy several blood pressure testing machines. The doctors issued a letter of credit to the seller upon the representation that it would only be used as security by the supplier and would never be called. The seller, however, did not deliver the equipment and contrary to the representations made to the doctors, pledged the letter to its bank as security for a general loan. As in *NMC*, the court held that fraud in the underlying transaction was an exception to the independence principle.<sup>80</sup>

Several cases have strongly emphasized the independence of the letter of credit from the underlying transaction and seem to be contrary authority for granting an injunction due to fraud in the underlying transaction. However, none of those courts actually found fraud in the underlying transaction. Thus, the courts' strong language, while perhaps persuasive authority, should be viewed properly as *dictum*.

In *Cappaert Enterprises v. Citizens & Southern International Bank*,<sup>81</sup> a suit to enjoin payment of a credit based upon allegations of fraud in the underlying transaction, a Louisiana federal district judge stated: "It is axiomatic that C & S Bank's obligation under its letter of credit is independent of, and therefore not affected by, the veracity of Cappaert's allegations of fraud by United Fisheries in the underlying joint venture."<sup>82</sup> However, the court noted later that Cappaert had not made a sufficient factual showing of fraud in the underlying transaction, and the court's rejection of this "underlying fraud" theory is therefore only *dicta*.<sup>83</sup> The supreme court in *Cromwell* relied on *Cappaert* as strongly supporting the independence principle, yet failed to note that the references to the independence principle were *dicta*.<sup>84</sup>

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78. *Id.* at 875, 337 N.Y.S.2d at 490.

79. 687 F.2d 1257 (8th Cir. 1982).

80. [W]here the draft itself and the underlying transaction are tainted with fraud or actual knowledge that the underlying transaction is being wholly thwarted by the beneficiary . . . , the draft need not be honored. Under the circumstances here presented, the salutary commercial doctrine of the independence of the letter of credit from the underlying transaction has no application.

*Id.* at 1261.

81. 486 F. Supp. 819 (E.D. La. 1980).

82. *Id.* at 826.

83. *Id.* at 829.

84. 464 So. 2d at 733.

Similar language can be found in *KMW International v. Chase Manhattan Bank*,<sup>85</sup> where payment of a letter of credit was not excused by the United States' embargo of shipments to Iran. The court held that the "unsettled situation in Iran"<sup>86</sup> which made performance impossible, was insufficient to release the parties from their obligation. As in *Cappaert*, there was no proof of fraud and thus the court's discussion of the independence from the underlying transaction is *dicta*.

Even the court in *O'Grady v. First Union National Bank*,<sup>87</sup> a case frequently cited as upholding the independence principle and rejecting the fraud in the underlying transaction principle, probably would have enjoined had there been a sufficient showing of fraud in the transaction. At issue in that case was whether the beneficiary's failure to obtain additional collateral from other parties to the agreement constituted fraud in the transaction. One letter of credit authority analyzed the *O'Grady* decision as follows:

The court concluded that . . . the strong policy of Article 5 is to keep separate the issuer's duty to honor drafts under the letter from the underlying contract between beneficiary and customer.

Nonetheless, the court concluded that an injunction would be proper under Section 5-114(2)(b) if the documents presented were a "product of fraud," citing the *Sztejn* case with approval. The court remanded for a determination of whether the beneficiary bank was aware of a condition imposed by *O'Grady* that the underlying notes be secured by additional collateral. If the bank knew of this condition, the draft and notice of default would be a "product of fraud" sufficient to justify the injunction and cancel the letter.<sup>88</sup>

As the analysis indicates, the *O'Grady* court seemed perfectly willing to grant an injunction due to fraud. Though this writer disagrees with the *O'Grady* court's reasoning, which seems to focus on fraudulent documents rather than fraud in the transaction, the thrust of the opinion is that fraud in the transaction would justify an injunction.

In light of the jurisprudence outlined above, this writer feels that the supreme court in *Cromwell* could have written an opinion strongly in favor of the fraud in the underlying transaction theory. Instead, the court reluctantly acknowledges that an injunction may issue for non-documentary fraud. The court began its analysis with *Sztejn*, recognizing that that court "refused to allow a seller-beneficiary to profit from its

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85. 606 F.2d 10 (2d Cir. 1979).

86. *Id.* at 16.

87. 296 N.C. 212, 250 S.E.2d 587 (1978).

88. B. Clark, *supra* note 7, at 8-60 to 8-61.

own fraudulent conduct.”<sup>89</sup> The court next analyzed *Shaffer v. Brooklyn Park Garden Apartments*,<sup>90</sup> a case involving fraudulent documents. The court then discussed *O’Grady*, and found that it dealt with fraudulent documents, rather than fraud in the transaction as the plaintiffs urged.

The court then reviewed *Colorado National Bank of Denver v. Board of County Commissioners*.<sup>91</sup> In that case a land developer issued a letter of credit in favor of the county to secure the developer’s promise to build certain roads in a proposed subdivision. Though the development was abandoned, the county attempted to collect on the letters of credit. The issuing bank refused to honor the credits because the county’s recovery would constitute a windfall. The banks argued that such a “windfall” recovery fell within the “fraud in the transaction” exception.<sup>92</sup> The court emphasized the independence of the letters of credit from the underlying transaction but later noted that fraud in the transaction between the county and developer had never been raised as an issue.<sup>93</sup>

The *Cromwell* court next reviewed *Cappaert* which, like *Colorado National Bank*, contained only *dicta* supporting the independence principle.

The court summarized its analysis of the jurisprudence stating, “[a]s illustrated in the foregoing cases the independence principle is a strong influence in the decision of cases throughout the country. Adherence to that basic principle is necessary in order to protect the commercial utility of letters of credit.”<sup>94</sup> At this point in the opinion the reader is left with the impression that the court is going to adopt the position that only fraudulent documents will support an injunction. The court continued, stating, “[n]evertheless, the jurisprudence and literature recognize and illustrate the need to extend the meaning of ‘fraud in the transaction’ at least a step beyond fraudulent documentation. The strongest reason for such an extended interpretation is to deny rewarding fraudulent conduct by letter of credit beneficiaries.”<sup>95</sup> The court cited one treatise in support of this position, but did not cite any cases, review the legislative history, or distinguish any of the apparently contrary cases, *O’Grady* and *Cappaert* for example.

In addition to the court’s rather reluctant application of the fraud in the underlying transaction theory, the court granted little deference

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89. 464 So. 2d at 731

90. 311 Minn. 452, 250 N.W.2d 172 (1977).

91. 634 P.2d 32 (Colo. 1981).

92. *Id.* at 39.

93. *Id.* at 40.

94. 464 So. 2d at 733.

95. *Id.*



to the trial court's substantial factual findings of fraud.<sup>96</sup> Thus, even though the court has adopted the fraud in the underlying transaction theory, the supreme court's restrictive interpretation of what constitutes fraud will probably result in few injunctions.

On the other hand, *Cromwell* can be read more broadly. The court did not require that EAB actively participated in the fraud. Rather, had EAB made the loan to CI with knowledge of the fraud that had been practiced upon the investors months earlier, it would have been unable to collect on the credits. Another distinction between *Cromwell* and the jurisprudence discussed above is that the latter, with the exception of *Banco Tornquist*, involved fraudulent performance and not fraudulent inducement in obtaining the letter of credit, as was apparently the case in *Cromwell*. The court in *Hohenberg Co., Inc. v. Comitex Knitters, Ltd.*,<sup>97</sup> suggested that only fraudulent performance should be sufficient to enjoin payment of the letter of credit.<sup>98</sup> The opinion does not explain the reason for distinguishing between fraudulent performance and fraudulent inducement in granting an injunction. A strict interpretation of the independence principle would possibly support recognizing such a distinction. Those who support the independence principle feel that since the letter of credit is independent from the underlying transaction, only fraudulent documents should support an injunction. Granting an injunction based on fraudulent documents does not, in their view, destroy the independence principle because the documents are integral to the actual letter of credit transaction—the transaction between the issuing bank and the beneficiary.<sup>99</sup> The *O'Grady* court and others feel<sup>100</sup> that any fraud in the performance of the underlying transaction is reflected in the documents, causing them to be fraudulent. For example, under their theory if fraudulently nonconforming merchandise is shipped, the bill of lading showing a shipment of conforming merchandise is itself

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96. *Crowell*, No. 82-6413-H, Reasons for Judgment (15th La. Dist. Ct. Feb. 10, 1983).

97. 104 Misc. 2d 232, 428 N.Y.S.2d 156 (Sup. Ct. 1980).

98. *Id.* at 234, 428 N.Y.S.2d at 158. The court relied upon *Foreign Venture Ltd. Partnership v. Chemical Bank*, 59 A.D.2d 352, 399 N.Y.S.2d 114 (1977), as authority for only allowing an injunction due to fraudulent performance and not fraud in the inducement, though its reason for doing so is far from clear. The issue in *Foreign Venture* was whether payment on a loan, made to the beneficiary of a standby letter and later reclaimed by the customer's liquidator, should have been counted as payment for purposes of the letter of credit. The court held that such a dispute did not constitute fraud in the transaction. The dispute occurred after the credit had been issued. Thus, there was no fraud, and even if there had been, it would have occurred after the inducement to issue the letter.

99. See discussion *supra* text accompanying notes 5-22.

100. See B. Clark, *supra* note 7, at 8-55 to 8-57.

fraudulent.<sup>101</sup> In the case of fraud in the inducement, the fraud would not be reflected in the documents. Conversely, the language of Section 5-114 does not support distinguishing between fraud in the performance and fraud in the inducement. Section 5-114 allows an injunction for fraudulent documents or fraud in the transaction. Recognizing the above-mentioned distinction between fraud in the performance and fraud in the inducement is particularly important in a standby letter of credit because it involves few, if any, documents. To deny an injunction based on fraud in the inducement would leave a standby letter of credit customer with virtually no judicial protection. The purpose of the injunction provision is to prevent an unscrupulous beneficiary from defrauding his innocent customer. Denying injunctive relief to an innocent customer who has been defrauded in a standby letter of credit transaction seems contrary to this purpose.

### *Assignment of the Letters of Credit*

The other issue raised by *Cromwell* is whether an assignee of the beneficiary of the letter of credit should be subject to this remedy. Under Louisiana law an assignee of a contract right steps into the shoes of his assignor. The assignee acquires all of the rights, no more and no less, that his transferor had.<sup>102</sup> Conversely, an assignee is subject to all of the defenses that could be asserted against the transferor.<sup>103</sup> For example, in *Smith v. Richland Compress & Warehouse Co.*,<sup>104</sup> the most recent Louisiana Supreme Court decision on this point, the assignee of a warehouse full of cotton sued the defendant who was engaged in the cotton storing business. The court stated, "[a]ll the defenses which were available against these parties [the assignors of the cotton], were open to [the] defendant in this case."<sup>105</sup> The law of assignment is the same in common law states.<sup>106</sup> The trial court found that there was an assignment of the letters of credit, but in an effort to protect EAB, treated an assignee-beneficiary as a potential holder in due course. The third

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101. Comment, *supra* note 16, at 1006-07.

102. See *Young v. Cistac*, 157 La. 771, 103 So. 100 (1925); *Halbert v. Klauer Mfg. Co.*, 181 So. 75 (La. App. 2d Cir. 1938); *Edwards v. Terminix*, 292 So. 2d 851 (La. App. 2d Cir. 1974).

103. See, e.g., *National Am. Bank v. Southcoast Contractors*, 276 So. 2d 777 (La. App. 1st Cir. 1973).

104. 153 La. 820, 96 So. 668 (1923).

105. *Id.* at 821, 96 So. at 669.

106. (1) By an assignment the assignee acquires a right against the obligor only to the extent that the obligor is under a duty to the assignor . . . .

(2) The right of an assignee is subject to any defense or claim of the obligor which accrues before the obligor receives notification of the assignment, but not to defenses or claims which accrue thereafter. . . .

circuit, as noted earlier, mischaracterized the structure of the standby transaction by finding that EAB was a fourth party, and not involved in the fraud practiced by the seller, Combined Equities, on its customers. The trial court's opinion indicates a contrary finding, which is also supported by the record. The trial court found EAB to be an assignee of Combined Investments, the original beneficiary.<sup>107</sup>

The supreme court characterized the letter of credit transaction in a way which gave EAB the greatest possible protection. CI is named as the beneficiary on the letter of credit. However, the transmittal letter accompanying the credit provides that: " 'European American Bank & Trust shall be deemed for all purposes to be the beneficiary of the Letter of Credit.' "<sup>108</sup> The court apparently viewed the language in the transmittal letter as controlling and treated EAB as if it had been the original beneficiary. Had the court treated EAB as a transferee-beneficiary,<sup>109</sup> a more difficult issue would have been presented. The court would have had to decide whether EAB could be prevented from collecting under the credit not because of its own fraud, but because of the fraudulent conduct of CI.

This writer submits that the supreme court purposely avoided this difficult issue and chose to give EAB the greatest possible protection by treating it as the original beneficiary. In this respect, the supreme court, third circuit, and trial court opinions are similar. None of the courts were willing to subject a third party lender in a standby letter of credit to the defenses available against its transferor.<sup>110</sup>

Had the court treated EAB as an assignee of the letter of credit, this comment suggests that, based on letter of credit law and Louisiana assignment law, the payment of the credit should have been enjoined.

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(3) Where the right of an assignor is subject to discharge or modification in whole or in part by impracticability, public policy, non-occurrence of a condition, or present or prospective failure of performance by an obligee, the right of the assignee is to that extent subject to discharge or modification even after the obligor receives notification of the assignment.

Restatement (Second) of Contracts § 336 (1979).

107. *Cromwell*, No. 82-6413-H, Reasons for Judgment (15th La. Jud. Dist. Ct. Feb. 10, 1983).

108. 464 So. 2d at 737.

109. Some portions of the opinion indicate that the credits were transferred from CI to EAB. The court referred to EAB as the "final beneficiary" indicating that some type of transfer occurred. 464 So. 2d at 723. The court in its statement of the facts noted: "This reissuance was accomplished by having new letters of credit issued in favor of C.I., Ltd. and then transferring those letters of credit to EAB." *Id.* at 727.

110. In this respect the supreme court opinion is similar to both the trial court's and the third circuit's. The trial court treated EAB as a potential holder in due course, despite the fact that a letter of credit is not a negotiable instrument. See discussion *infra* at 22. The third circuit characterized EAB as an original party to the transaction.

As an assignee of the credit itself, EAB would have had the right to draw its own drafts under the credit. In such a situation, since the drafts are drawn by the assignee himself, there can be no negotiation.<sup>111</sup> Therefore, it would not have been possible for EAB to take the drafts under circumstances which would make it a holder in due course.<sup>112</sup> Since there was no negotiation of the drafts, EAB could never be a holder and since it never gave value, certainly could not have holder in due course status under Section 5-114(2)(a),<sup>113</sup> which provides that an issuing bank must pay a holder in due course of drafts despite allegations of fraudulent documents or fraud in the transaction. Thus EAB, as a holder of a non-negotiable letter of credit, could never qualify for the holder in due course protection offered in Section 5-114(2)(a). The appropriate inquiry, therefore, is what rights EAB should have had as an assignee-beneficiary of a letter of credit to collect payment.

The Louisiana law of assignment, which applies to contract disputes generally, should apply to the situation in *Cromwell*, unless the more specialized law governing letters of credit supplements or restricts the general law in any way. A review of the letter of credit provisions contained in Louisiana Revised Statutes 10:501 *et seq.* indicates that there is no restriction on the assignment of letters of credit. Louisiana Revised Statutes 10:5-116<sup>114</sup> provides two methods by which a letter of credit can be assigned: Section 5-116(1) allows an assignment of the letter of credit itself and gives the assignee the right to draw drafts; Section 5-116(2) allows an assignment of the proceeds of the letter, similar to an assignment of accounts receivable. The comments to that article indicate that the normal rules of assignment should apply to assignments of a letter of credit.<sup>115</sup>

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111. A negotiation requires that an instrument be transferred and delivered. See La. Com. Laws § 10:3-202(1). A negotiation is required in order for one to be a holder. See La. Com. Laws § 10:3-202, Comment 1.

112. La. Com. Laws § 10:3-302 requires that a holder in due course take the instrument for value. EAB did not give value for the drafts, but gave value for the letters of credit themselves.

113. See *supra* note 4.

114. (1) The right to draw under a credit can be transferred or assigned only when the credit is expressly designated as transferable or assignable.

(2) Even though the credit specifically states that it is nontransferable or nonassignable the beneficiary may before performance of the conditions of the credit assign his right to proceeds. Such an assignment is an assignment of a credit right under the Civil Code and is governed by the articles thereof.

(3) Except where the beneficiary has effectively assigned his right to draw or his right to proceeds, nothing in this section limits his right to transfer or negotiate drafts or demands drawn under the credit.

La. Com. Laws § 10:5-116.

115. *Id.* § 10:5-116, Comment 1.

Although several cases have interpreted Section 5-116(2),<sup>116</sup> there have been no reported cases finding an assignment of the letter of credit itself under Section 5-116(1). *Cromwell* is the first case in the country whose facts fit squarely under paragraph 1. In order to provide an accurate decision and to furnish guidance to other jurisdictions on this point, the supreme court should have corrected the interpretive errors made by both the trial and appellate courts and applied section 5-116(1), the appropriate statute, to the case.

In addition to the lack of jurisprudential guidance under Section 5-116(1), there is little doctrinal authority interpreting that statute. The authority that does exist, however, supports subjecting an assignee-beneficiary to the defenses assertable against its assignor. As mentioned above, the statute clearly allows an assignment of the letter itself and the comments direct the reader to general assignment law. The experts who have considered the problem have also looked to general assignment law in determining the rights of an assignee-beneficiary of a letter of credit. An assessment of this problem made by a commentator nearly 40 years ago is still relevant today:

The word "assignable" has an altogether different meaning from that of the word "negotiable," and the mere fact that a credit has been validly assigned would not be sufficient to overcome defenses or set-offs which would be good against the assignor (seller-beneficiary). Possibly the fact that a credit contains words of express assignability might be sufficient to raise an estoppel in favor of an assignee, as against such defenses or set-offs, but this would hardly seem to square with the rule of law that defenses good against an assignor are good against his assignee. If a court had before it a "straight" credit (by the terms of which no one could become a holder in due course of drafts drawn under it) it would seem that even if it contained express words of assignability the assignee might be confronted with defenses or set-offs which are good against the assignor. Even in the case of a credit under which it is possible for third parties to acquire rights superior to those of the beneficiary, *i.e.*, a "negotiation" credit, an assignee (even if the credit contained express words of assignability) might not acquire such superior

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116. For example, in *Bank of Newport*, 687 F.2d 1257 (8th Cir. 1982), the court, referring to an assignment of the proceeds under a letter of credit, stated that:

*Bank of Newport*, as assignee, stands in the shoes of *Fiscal*, and obviously *Fiscal* had no right to draw on the letter of credit without making provision for the delivery of the machines. *Bank of Newport*, as assignee, only had the right to receive payment on drafts properly drawn by the beneficiary *Fiscal*. 687 F.2d at 1261. See also *Shaffer v. Brooklyn Park Garden Apts.*, 311 Minn. 452, 250 N.W.2d 172 (1977).

rights. Such rights are assured only to parties who take, not by assignment of the credit, but by negotiation in good faith of drafts drawn under it.<sup>117</sup>

The importance of this excerpt is that a third party can insulate himself from defenses by receiving drafts drawn under the letter of credit and meeting the requirements of the holder in due course. If the third party fails to take advantage of this protection by having drafts negotiated to him, and instead takes an assignment of the letter of credit, he would be relegated to the status of a mere assignee, subject to all claims and defenses available to the customer against the original beneficiary. The article also noted that such a rule should not destroy the commercial utility of letters of credit, as the trial judge in *Cromwell* thought it might, but rather it should enhance it.<sup>118</sup> The author explained that the assignee could have opted for holder in due course status.<sup>119</sup> Furthermore, since few defenses can be asserted against a beneficiary in a letter of credit transaction (*viz.*, forgeries or fraudulent documents or fraud in the transaction), the risk that the assignee will not collect is minimal. The beneficiary, on the other hand, realizes a tremendous benefit by being able to assign the letter and obtain the financing needed to produce goods or otherwise perform his obligation to the customer. The customer receives a corresponding benefit as the assignment enables him to get the performance he desires at a favorable rate.<sup>120</sup>

The same principle should apply equally today in a standby letter of credit situation, such as that in *Cromwell*. The general partner should be able to assign the letter of credit just as he would assign stock certificates, for example, in order to get the necessary financing for the limited partnership.

A more recent commentator has also reviewed the subject of the assignability of the letter of credit. Professor Barkley Clark has stated that an assignee-beneficiary of a letter of credit should be subject to all of the defenses of the original beneficiary.<sup>121</sup> He discussed ways in which an assignee of a letter of credit could insulate himself from possible defenses.<sup>122</sup> In *Cromwell*, for example, EAB could have requested that it be given drafts drawn under the letter of credit by Combined Equities. Based on the statute and the doctrinal writers who have ad-

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117. McGowan, Assignability of Documentary Credits, 13 Law & Contemp. Probs. 666, 678 (1948).

118. *Id.* at 680.

119. *Id.*

120. *Id.*

121. B. Clark, *supra* note 7, at 8-77 ("A transferee beneficiary would presumably be subject to any defenses or setoffs which the issuer has against the assignor.").

122. B. Clark, *supra* note 7, at 8-33 (1984 Cumulative Supp. No. 2).

dressed the issue, the correct resolution of the situation in *Cromwell*, and in any situation involving an assignment of the letter itself, is to subject the assignee to all defenses its assignor is answerable for. The good faith or notice of the assignee is irrelevant. The pertinent inquiry is into the transaction between the customer or investor and the beneficiary. The trial judge's reliance on Louisiana Civil Code article 21<sup>123</sup> in an effort to give EAB the greatest possible protection, while perhaps laudable, did violence to the theory of the specialized status of a holder in due course. The impact of the trial court's analysis is that an assignee (in *Cromwell*, a major New York bank that could have easily protected itself initially) will be given a chance to improve its status after the fact. A more onerous burden is imposed on the plaintiff-investor, who has to prove a defense against the beneficiary and, additionally, bad faith or notice on the part of the assignee.

Such a burden is not justified by the clear wording of the statute or by the authority on the point.

### *Conclusion*

*Cromwell* illustrates the competing principles of the commercial utility of letters of credit and the commercial expectation of honesty and fair dealing in the context of a standby letter of credit. In reconciling these two principles, the statute provides, and jurisprudence has held that the independence principle must yield to the strong policy against fraud—either in the documents or in “the transaction.”

A few courts and commentators have analyzed the exception to the independence principle as encompassing only fraudulent documents. Such an analysis treats fraudulent documents and fraud in the transaction as referring to the same type of fraud. Fraud in the performance of the underlying transaction will not always result in fraud in the documents. Furthermore, based on such an analysis, fraud in the inducement of the underlying contract would never justify an injunction.

Limiting the availability of an injunction to fraudulent documents is especially devastating to a standby letter of credit customer who has few, if any, documents to protect him. The *Cromwell* holding that an injunction should issue due to fraud in the underlying transaction offers some protection to the standby customer. However, the supreme court's characterization of EAB as the original beneficiary indicates that the court will make every effort to allow a third party lender to collect on

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123. “In all civil matters, where there is no express law, the judge is bound to proceed and decide according to equity. To decide equitably, an appeal is to be made to natural law and reason, or received usages, where positive law is silent.” La. Civ. Code art. 21.

the credit. Based on *Cromwell* it will be very difficult for a standby customer to prove that the holder of the credit, usually a third party lender, committed or knew of the fraud.

In this writer's opinion, the extra protection afforded EAB was not warranted by the facts of the case. The trial court's factual findings indicate that the credits were assigned to EAB. Had these factual findings been followed, EAB should have been enjoined regardless of its complicity in the fraud perpetrated by CI and CE. If the beneficiary assigns his letter of credit, his transferee should step into the shoes of the transferor. Such a rule is consistent with general contract law in Louisiana and throughout the rest of the country. This rule is also consistent with letter of credit law which specifically authorizes an assignment of letters of credit. A transferee of a non-negotiable letter of credit should not be given the specialized status of a holder in due course.

Letters of credit must be recognized for what they are—commercial instruments subject to certain statutory exceptions. They should not be treated as gold bullion.

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