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Letter of Credit Litigation - Bank Liability for Punitive Damages

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LETTER OF CREDIT LITIGATION—BANK LIABILITY FOR PUNITIVE DAMAGES

INTRODUCTION

Punitive damages punish defendants for malicious conduct and presumably deter others from acting similarly.¹ Punitive damage liability in purely business lawsuits is particularly controversial.² Some authorities argue that the availability of punitive damages discourages legitimate commercial conduct,³ while others contend that punitive damages deter egregious conduct.⁴ Recent letter of credit litigation raised the issue of whether punitive damages are available under the Uniform Commercial Code (UCC).⁵


3. See Ellis, Fairness and Efficiency in the Law of Punitive Damages, 56 S. Cal. L. Rev. 1, 69-71 (1982); Insurability of Punitive Damages, supra note 2, at 1388-89. When punitive damages are assessed vicariously against a corporation, the employer himself did nothing to warrant punishment, and the potential for liability may not induce employers to screen or train employees more carefully. See Ellis, supra, at 69. The loss falls on the public through the increased cost of goods or on the shareholders, both of whom are innocent. Id. at 69-70.

4. See, e.g., Grimshaw v. Ford Motor Co., 119 Cal. App. 3d 757, 820, 174 Cal. Rptr. 348, 389 (1981) ("It is precisely because monetary penalties under government regulations prescribing business standards or the criminal law are so inadequate and ineffective as deterrents against a manufacturer and distributor of mass produced defective products that punitive damages must be of sufficient amount to discourage such practices."); Kelsay v. Motorola, Inc., 74 Ill. 2d 172, 187, 384 N.E.2d 353, 359 (1978) (where criminal sanctions "would do little to discourage the practice of retaliatory discharge," punitive damages are appropriate).

The letter of credit developed in international transactions as a means of lessening risks to both buyer and seller. Letters of credit are commercially desirable because they promote certainty in transactions, thereby eliminating the barrier of distrust between distant or unfamiliar parties. The Uniform Commercial Code (UCC) defines a “letter of credit” or “credit” as “an engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.” U.C.C. § 5-103(1)(a) (1977); see H. Harfield, Bank Credits and Acceptances 29-33 (5th ed. 1974); J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 18-2, at 711-15 (2d ed. 1980); see also International Chamber of Commerce, Uniform Customs and Practice for Documentary Credits (UCP), art. 2 (Publ. No. 400) (rev. ed. 1983) (the UCP may also govern letter of credit law) [hereinafter cited as UCP]. For a discussion of the applicability of the UCC and the UCP, see infra note 13.

Without a letter of credit, the seller would not want to ship the goods until receiving payment. The seller prefers to avoid the risk of the buyer’s insolvency, rejection of the goods or refusal to pay. In these scenarios, the seller might have to accept less than the contract price, try to find another purchaser, pay extra transportation charges, or sue, possibly in a foreign or unfamiliar jurisdiction. On the other hand, the buyer is reluctant to prepay before shipment because of the chance that he will either not receive the goods or receiving nonconforming goods, leaving him in the same undesirable position as the seller who does not receive payment. With the letter of credit, both parties can reduce or eliminate risk of nonpayment and nondelivery of goods.

The customer specifies the documents the beneficiary must obtain before receiving payment, such as a bill of lading, thus giving the customer some evidence that the goods were shipped. For additional protection, the customer can require that a neutral third party inspect the goods and certify their conformance with the requirements of the underlying contract. The customer is likely to require an inspection certificate because without it the seller/beneficiary will receive payment on the letter of credit before the customer can examine the goods. The beneficiary knows that by shipping the goods and obtaining the required documents, the issuer’s obligation to pay is triggered. Moreover, banks are likely to remain solvent. The seller also has the protection of holding the documents controlling the goods until the issuer pays. Thus, the buyer cannot receive the goods until the issuer pays. See J. Dolan, The Law of Letters of Credit: Commercial and Standby Credits ¶ 3.07[5], at 3-28 (1984); J. White & R. Summers, supra note 6, § 18-1, at 707; Harfield, supra note 7, at 241. Moreover, both parties benefit from the issuer’s experience in checking document conformity. The bank’s objective role promotes a greater willingness by a buyer and seller to enter into a contract, particularly where the parties are geographically distant and thus may have difficulty monitoring the other party’s financial status. See A. Lowenfeld, International Private Trade 77, § 5.3, at 130 (2d ed. 1981).

The issuer paying the draft acquires documents of title to the goods, thereby securing a reimbursement claim against the buyer. See J. White & R. Summers, supra note 6, § 18-
If a contract requires a letter of credit, the buyer, known as the customer, obtains a letter of credit from its bank, called the issuer, designating the seller as beneficiary. The letter of credit obligates the issuer to pay the beneficiary when the beneficiary presents certain documents relating to the transaction. If the documents conform to those required by the letter, the issuer must pay the beneficiary without regard to the underlying sales contract.

Article 5 of the UCC, governing letters of credit, also governs the standby letter of credit. In the typical standby letter of credit, the bene-

1. at 707-08. If an issuer wants greater protection against its customer, it can also require additional collateral or a deposit to cover the letter of credit payment. See id. at 708 n.11.

9. The "customer" is a buyer or other person who causes an issuer to issue a credit. U.C.C. § 5-103(1)(g) (1977). The customer is sometimes referred to as an accredited buyer, importer, consignee or account party. H. Harfield, supra note 6, at 33.

10. The "issuer" is a bank or other person issuing a credit. U.C.C. § 5-103(1)(c) (1977). While this definition indicates that an issuer need not be a bank, the issuer must be a party of known solvency for the letter of credit to function properly. See B. Kozolchyk, Commercial Letters of Credit in the Americas § 1.01[3], at 9 (1966). In fact, Article 5 was revised to specifically allow nonbank issuers. J. White & R. Summers, supra note 6, § 18-1, at 710 & n.18. Nevertheless, the overwhelming majority of issuers are banks and this Note focuses exclusively on bank liability.

11. The "beneficiary" of a credit is a person who is entitled under its terms to draw or demand payment. U.C.C. § 5-103(1)(d) (1977).

12. U.C.C. § 5-114(1) (1977) states that "[a]n issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary." Similarly, U.C.C. § 5-109(1)(a) (1977) provides that "[a]n issuer's obligation to its customer . . . unless otherwise agreed does not include liability or responsibility (a) for performance of the underlying contract for sale or other transaction between the customer and the beneficiary . . . ." The letter of credit is a separate agreement, independent of the underlying transaction between the customer and the beneficiary. See J. White & R. Summers, supra note 6, § 18-2, at 711-12.

13. The UCP may also govern letters of credit. Parties to a letter of credit transaction may specify that the UCP applies. See U.C.C. § 1-105 (1977); J. White & R. Summers, supra note 6, § 18-3, at 717.

Additionally, New York, Alabama and Missouri have added a fourth subsection to § 5-102 of their versions of the UCC. Section 5-102(4) provides as follows:

Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits. . . .


14. The standby letter of credit is "any letter of credit . . . which represents an obligation to the beneficiary on the part of the issuer . . . to make payment on account of any indebtedness undertaken by the account party, or . . . to make payment on account of any default by the account party in the performance of an obligation." 12 C.F.R. § 7.1160(a) (1982); see McLaughlin, Standby Letters of Credit & Penalty Clauses: An Unexpected Synergy, 43 Ohio St. L.J. 1, 6-7 (1982).
ficiary, who is unfamiliar with the issuer requires a familiar bank to serve as the confirming bank, which agrees to pay the face value of the letter of credit only on default by its customer—the original issuer—or on failure of performance in the underlying contract. Thus, the standby letter of credit is the functional equivalent of a guarantee.

Although both parties benefit from the transaction, the letter of credit often performs an important forum-shifting function in favor of the bene-

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15. The confirming bank provides additional security of payment to the beneficiary because the confirming bank becomes directly obligated on the letter. See U.C.C. § 5-107(2) (1977) (confirming bank assumes obligations of issuing bank); id. § 5-115 (beneficiary's remedy if issuer wrongfully dishonors); H. Harfield, supra note 6, at 44-45; J. White & R. Summers, supra note 6, § 18-1, at 707; id. § 18-2, at 713.

16. A “confirming bank” is a bank which engages either that it will itself honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank.” U.C.C. § 5-103(1)(f) (1977).

17. “The term [customer] also includes a bank which procures issuance or confirmation on behalf of that bank's customer.” Id. § 5-103(1)(g).

18. There may be other parties involved in the letter of credit transaction. An advising bank, see id. § 5-103(1)(e), for example, is a party who facilitates a letter of credit but has limited liability. See J. Dolan, supra note 8, ¶ 1.03, at 1-11 (1984); T. Quinn, Uniform Commercial Code Commentary and Law Digest ¶ 5-103[A][4], at 5-15 (1978). The advising bank communicates the fact of issuance and the terms of the letter of credit and is usually located in the beneficiary's locale. See J. Dolan, supra note 8, ¶ 1.03, at 1-11; T. Quinn, supra, ¶ 5-103[A][4], at 5-15. The advising bank communicates the fact of issuance and the terms of the letter of credit and is usually located in the beneficiary's locale. See J. Dolan, supra note 8, ¶ 1.03, at 1-11; T. Quinn, supra, ¶ 5-103[a][4], at 5-15. The advising bank assumes no liability with respect to the credit except to transmit the information accurately. See U.C.C. ¶ 5-107(1) (1978); U.C.P. art. 8; 2 A. Squillante & J. Fonseca, The Law of Modern Commercial Practices § 7:3, at 229 (rev. ed. 1981); id. § 7:7, at 234. The advising bank assumes the obligation of accuracy of its own statements. U.C.C. ¶ 5-107(1) (1977). Issues concerning the liability of the advising bank and the liability of another party to the advising bank are beyond the scope of this Note.

19. See Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 394 (D. Md. 1982), aff'd, 704 F.2d 136 (4th Cir. 1983); J. White & R. Summers, supra note 6, at 709; McLaughlin, supra note 14, at 6. A guaranty and a letter of credit do differ in certain ways. See J. White & R. Summers, supra note 6, § 18-2, at 713-14. A guarantor becomes liable only after the obligor does not pay, whereas the confirming bank is primarily liable on the letter. See, e.g., Barclays Bank D.C.O. v. Mercantile Nat'l Bank, 481 F.2d 1224, 1236 (5th Cir. 1973), cert. dismissed, 414 U.S. 1139 (1974); Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 394 n.23 (D. Md. 1982), aff'd, 704 F.2d 136 (4th Cir. 1983); see U.C.C. ¶ 5-107(2) (1977) (confirming bank becomes directly obligated on the credit as though it were the issuer); id. ¶ 5-109 (issuer responsible for documents only, not underlying facts). Moreover, the guarantor becomes obligated only when the principal debtor actually defaults; the issuer, however, must pay as long as the documents presented conform to the terms of the letter, regardless of the underlying facts. See, e.g., Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F.2d 1285, 1286 (9th Cir. 1974) (per curiam); J. White, & R. Summers, supra note 6, § 18-2, at 713; see also U.C.C. §§ 5-107, -109 (1977). These differences are significant because a national bank is not permitted to issue a guaranty. See Kimen v. Atlas Exch. Nat'l Bank, 92 F.2d 615, 617-18 (7th Cir. 1937), cert. denied, 303 U.S. 650 (1938); Lord, The No-Guaranty Rule and the Standby Letter of Credit Controversy, 96 Banking L.J. 46, 61-62 (1979); see also 12 U.S.C. § 24 (1982) (enumerated powers of a national bank do not include power to issue guaranties).
Without the letter, the customer could withhold payment in the event of a dispute. The beneficiary would then have to sue the customer, possibly in a foreign jurisdiction. With a letter, however, the issuer must pay the beneficiary if the documents conform, despite any disagreement concerning the underlying contract. The beneficiary thus becomes the stakeholder. If a dispute arises, execution of the letter forces the customer to sue the beneficiary.

Because the drafters of the UCC realized that the commercial development of letters of credit required flexible legal rules, the UCC is somewhat ambiguous with respect to the range of remedies available to the parties to a letter of credit transaction. In fact, Article 5 specifically prescribes a remedy only when the beneficiary sues the issuer or confirming bank. When an issuer or confirming bank wrongfully dishonors a demand for payment, section 5-115 permits the beneficiary to recover the face amount of the letter plus incidental damages, less any amount realized by resale. The Code defines the bank's obligations to the customer—to examine the documents "with care" and in good faith.

20. See J. White & R. Summers, supra note 6, § 18-1, at 706-07; McLaughlin, supra note 14, at 5.


22. The drafters recognized that no statute can effectively or wisely codify all the possible law of letters of credit without obstructing further development of this useful financing device. . . . [Section 5-102][3] makes explicit the court's power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so. Under Section 1-102(1) such application is to follow the canon of liberal interpretation to promote underlying purposes and policies. Since the law of letters of credit is still developing, conscious use of that canon and attention to fundamental theory by the court are peculiarly appropriate.


23. Id. § 5-115. Although the parties may sue on the underlying contracts, a primary reason for using the letter of credit is to avoid lawsuits on the underlying contract. See J. White & R. Summers, supra note 6, § 18-6, at 728. The customer and issuer also have a contract providing that the issuer will issue the letter, and the customer will reimburse the issuer for payments under the letter. Id. § 18-7, at 741.

24. U.C.C. § 5-115(1) (1977). If no resale is made, the documents, goods or other subject matter must be turned over to the issuer on payment of the judgment. Id.

25. Id. § 5-105(2); see United States v. Sun Bank, 609 F.2d 832, 833 (5th Cir. 1980) (per curiam); Instituto Nacional de Comercializacion Agricola (Indeca) v. Continental Ill. Nat'l Bank & Trust Co., 530 F. Supp. 279, 282 (N.D. Ill. 1982); Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 97 F. Supp. 92, 100 (M.D.N.C.), rev'd on other grounds, 528 F.2d 802 (4th Cir. 1975). Even if the issuer wrongfully honors and has failed to examine the documents "with care," the customer may not have a good claim against the issuer if their contract has a clause providing that the bank would not be responsible for the validity, sufficiency or genuineness of the documents. Courts have generally upheld such clauses. See J. White & R. Summers, supra note 6, at 741.

Nevertheless, the issuer should not be able to disclaim contractually its duty of care to its customer. See U.C.C. § 1-102(3) (1977). The parties may, however, determine standards of performance, provided such standards are not "manifestly unreasonable." Id.;
faith—but omits a remedy for the customer if the issuer breaches these duties. A confirming bank assumes the obligations of an issuer, but courts interpret a confirming bank's duty to run only to the issuer—the confirming bank's customer—and not to the ultimate customer.

Article 5 is silent on punitive damages. Consequently, the question of punitive damages arises only if the UCC permits remedies in addition to those prescribed by Article 5. Article 1 provides that the UCC does not automatically preempt all common law rights and obligations of parties to a commercial transaction. It also states that the remedies of the Code shall be "liberally administered" for the purpose of putting the aggrieved party in the same position it would have been had the other party performed fully. Although this provision emphasizes compensation, it also states that punitive damages may be awarded if specifically provided for by the Code itself or by other rule of law.

see J. White & R. Summers, supra note 6, at 742; Farrar, Incidents of Improper Performance, in Letters of Credit and Bankers' Acceptances 1985, 413, at 415.

In a provision similar to U.C.C. § 5-109(2), the UCP states that "[b]anks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit." U.C.P. art. 15.


27. This silence is probably due to the fact that lawyers for issuers greatly influenced the drafting of Article 5. J. White & R. Summers, supra note 6, § 18-7, at 741 (citing Rudolph B. Schlesinger's critique of the 1952 official text of Article 5 for the New York Law Revision Comm'n, 1955 Report 1571-1719, at 1630 (1955)).

The customer is not left without a remedy if the issuer wrongfully dishonors. He can sue the beneficiary for breach of the underlying contract or for breach of warranty under § 5-111, but there are risks involved. See supra note 23 and accompanying text. In fact, the customer may have sought the letter of credit to avoid these risks, such as beneficiary insololvency or litigation in a foreign jurisdiction. See supra note 23 and accompanying text. Alternatively, the customer can sue the issuer for breach of their reimbursement contract. See supra note 23 and accompanying text.


30. See infra notes 82-107, 112-144 and accompanying text.

31. U.C.C. § 1-103 (1977) states that "[u]nless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions." Therefore, common law applies unless the Code displaces it.

32. Id. § 1-106(1).

33. Id. Section 1-106(1) states:

The remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law.

34. Id. § 1-106 official comment 1 (one of the purposes of subsection (1) is "to make it
provided for in the UCC or by "other rule of law." Because Article 5 does not mention punitive damages, a letter of credit litigant may receive a punitive remedy only if it is available under some "other rule of law." 36

Under common law, punitive damages are awarded only when the defendant has acted in an outrageous manner and are most frequently awarded in tort actions. 37 Traditionally, punitive damages were not allowed in breach of contract actions. 38 More recently, however, courts have allowed punitive damages in contractual disputes involving separate tort claims. 39 Additionally, if the breach of contract is committed in a tortious manner, courts may award punitive damages. 40

These common law causes of action are available in letter of credit litigation only if they do not thwart the purposes of the Code. 41 Even if an appropriate cause of action meets this standard, punitive damages are not automatically available. Punitive damages are permitted only if they themselves do not thwart the purposes of the Code. 42

This Note will explore if and when an issuing bank or a confirming bank can be held liable for punitive damages in letter of credit litigation. Part I analyzes the interplay between common law and the UCC and concludes that common law liability may arise in letter of credit disputes, thereby raising the theoretical possibility of punitive damages as a rem-

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35. Id. § 1-106.
36. Id. § 1-106(1).

42. See infra notes 49-55 and accompanying text.
43. See infra notes 44-55 and accompanying text.
Part II then discusses whether allowing punitive damages would thwart UCC policies relating to letters of credit. This Note concludes that punitive damages should be permitted in limited circumstances because they would not thwart UCC policies and, in some cases, would promote secure use of letters of credit.

I. INTERPLAY BETWEEN COMMON LAW AND THE UCC

Section 1-103 provides that "[u]nless displaced by the particular provisions of [the UCC], the principles of law and equity . . . shall supplement its provisions." Accordingly, common law remedies for tort and breach of contract, and thus punitive damages, apply in letter of credit litigation as long as the Code does not provide the exclusive remedy. Although section 1-106 permits punitive damages by "other rule of law," section 1-103 may nevertheless displace that other rule of law. Section 1-103 therefore modifies section 1-106 and precludes punitive damages if the UCC displaces the underlying substantive claim.

Although the UCC displaces common law only when common law conflicts with UCC policy, determining such an inconsistency can be difficult. The Code's express intent to supplement it provisions with common law, to be "liberally construed" to promote its underlying

44. U.C.C. § 1-103 (1977).
45. See infra notes 72-144 and accompanying text.
47. Id. § 1-103. See infra notes 49-55.
48. See McLaughlin, Letters of Credit: Some Recent Cases, N.Y.L.J., Oct. 29, 1985, at 1, col. 1. Unfortunately, decisions discussing the availability of punitive damages for common law liability under § 1-106 fail to first expressly perform a § 1-103 analysis to determine if the Code displaces that substantive common law. See, e.g., Siegman v. Equitable Trust Co., 267 Md. App. 309, 315 n.3, 297 A.2d 758, 761 n.3 (1972) (dictum) (punitive damages permissible for conversion because § 1-106 permitted them and § 4-402 did not expressly preclude them); Davidson v. First Bank & Trust Co., 609 P.2d 1259, 1262-63 (Okla. 1977) (punitive damages permitted for conversion because bank sold repossessed collateral in commercially unreasonable manner); Z.D. Howard Co. v. Cartwright, 537 P.2d 345, 347-48 (Okla. 1975) (punitive damages permitted for material misrepresentation and breach of warranty under UCC because breach amounted to independent tort); Clayton v. Crossroads Equip. Co., 655 P.2d 1125, 1131 (Utah 1982) (punitive damages permitted under § 1-106 for repossession of goods because the defendant's conduct was wilful and malicious).

The few letter of credit cases dealing with the issue of punitive damages also fail to explicitly use a § 1-103 analysis. See Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399, 407-11 (1st Cir. 1985); Hubbard Business Plaza v. Lincoln Liberty Life Ins. Co., 596 F. Supp. 344, 346-47 (D. Nev. 1984). Although some courts indirectly perform a § 1-103 analysis by examining UCC policy, without a systematic analysis, it is difficult for banks and other business entities to conform their conduct to legal standards.

49. See infra notes 50-55 and accompanying text.
51. See id. § 1-102(2). The underlying purposes and policies of the U.C.C. are "to simplify, clarify and modernize the law governing commercial transactions; . . . to permit the continued expansion of commercial practices through custom, usage and agree-
purposes and policies,\textsuperscript{52} and to provide flexibility in commercial transactions\textsuperscript{53} should govern this analysis. Thus, under section 1-103, the Code should displace common law only if a UCC provision expresses a specific intent to displace the common law,\textsuperscript{54} or if the application of common law would thwart Code policy.\textsuperscript{55} If the Code is silent concerning the application of a particular common law rule, that rule should apply unless it thwarts UCC policy. Accordingly, unless permitting punitive damages would thwart the purposes and policies of Article 5, or of the UCC as a whole, they should be available if common law permits them.

The drafters intended Article 5 to set an "independent theoretical frame" for the development of letters of credit\textsuperscript{56} and emphasized their commercial utility as a reason for construing the UCC to promote their development.\textsuperscript{57} Encouraging the use of letters of credit concomitantly promotes a primary purpose of Article 1—to "permit the continued expansion of commercial practices."\textsuperscript{58} To determine whether the availability of punitive damages would thwart this policy, the unique nature of a letter of credit must be considered.

The issuing bank oversees documents, not the goods themselves or the facts represented by the documents.\textsuperscript{59} In deciding whether to honor a
beneficiary's demand solely by examining the facial conformity of the documents, the issuer performs a ministerial function. The minimal fee charged by the issuer reflects a commercial understanding of the issuer's limited function and risk. Most importantly, letter of credit law is governed by the independence principle, which provides that the letter is separate and independent from other agreements involved in the transaction. Thus, a letter of credit is essentially a payment guarantee for the beneficiary, provided he presents conforming documents. The issuer has no duty or liability relating to the underlying transaction.

The bank's independent obligation to pay gives the letter of credit its commercial vitality. Whether imposing tort or contract liability will deter the use of letters of credit should determine whether such liability is inconsistent with the policies of the Code. This determination will dif- not. See id. § 5-114(2)(b). The customer is also permitted to seek a court injunction so that the issuer does not have to pay. See id. If a holder in due course makes the demand, however, this exception does not apply. See id. § 5-114(2)(a).

60. U.C.C. § 5-114(1) (1977) provides that

[a]n issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor . . . by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.


63. See Arbest Constr. Co. v. First Nat'l Bank & Trust Co., No. 83-1961, slip op. at 6, 8 (10th Cir. Nov. 19, 1985); Bank of Newport v. First Nat'l Bank, 687 F.2d 1257, 1261 (8th Cir. 1982); Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co., No. 83 Civ. 1767, slip op. at 8 (S.D.N.Y. July 9, 1985); J. White & R. Summers, supra note 6, § 18-2, at 241-42.

64. The "fraud in the transaction" exception represents a deviation from the independence principle. See supra note 59.

65. The fraud in the transaction may operate even if the beneficiary presents apparently conforming documents. See supra note 59 and accompanying text.

66. But see supra note 59 and accompanying text.

67. See supra note 63 and accompanying text.

68. See supra notes 44-55 and accompanying text.
fer in certain respects, depending on who is suing whom.

A. Beneficiary v. Issuer and Beneficiary v. Confirmer

The Code explicitly provides a remedy to the beneficiary if the issuer wrongfully dishonors.69 This remedy displaces a breach of contract cause of action.70 If the bank's conduct consists of more than just wrongful dishonor, however, the UCC should permit a tort cause of action.71

1. The Code Displaces a Common Law Contract Action

A common law contract action appears to be inconsistent with Article 5 and should be displaced by the Code. Because the letter of credit evolved as a mercantile specialty entirely separate from common law contracts, it must be construed as an independent entity.72 Within a limited scope, the drafters intended to set an independent theoretical frame for the further development of letters of credit.73 Accordingly, the Code establishes the purely statutory duties the issuer owes to the beneficiary.74 A breach of contract claim is coextensive with wrongful dishonor,75 for which the Code specifically provides a remedy.76 Consequently, the Code displaces a breach of contract action.

Moreover, even if contractual liability would not contravene Code po-

70. See infra notes 72-80 and accompanying text.
71. See infra notes 81-107 and accompanying text.
73. See U.C.C. § 5-102(3) & official comment 2 (1977).
74. When the letter is established, see id. § 5-106, the issuer becomes statutorily obligated to the beneficiary. J. White & R. Summers, supra note 6, § 18-2, at 711; Kozolchyk, Letters of Credit, in 9 International Encyclopedia of Comparative Law ch. 5, at 137-40 (1979); see also A. Lowenfeld, supra note 7, § 553, at 103 (although not contractual, beneficiary-issuer relationship has a "well defined set of rights and obligations"). Some courts and some official Code comments suggest a contractual nature to the issuer's obligation. See U.C.C. § 5-101 official comment (1977) ("other source of law respecting letters of credit is the law of contracts"); id. § 5-114 official comment 1 ("letter of credit is essentially a contract between the issuer and the beneficiary").
75. A breach of contract claim would be equivalent to a wrongful dishonor cause of action.
76. See U.C.C. § 5-115(1) (1977). "When an issuer wrongfully dishonors a draft or demand for payment . . . [the beneficiary] may recover . . . the face amount of the draft or demand together with incidental damages . . . less any amount realized by resale . . . ." Id. If no resale occurs, the issuer receives the subject matter involved on payment of the judgment. Id.
icy, the beneficiary cannot establish the essential elements of a contract claim. First, offer and acceptance do not necessarily occur. The issuer has no meaningful contact with the beneficiary; in fact, prior to the issuance of a letter of credit, the issuer and beneficiary may be unknown to each other. Furthermore, the Code states that consideration is not necessary to establish a letter of credit. Finally, because the issuer cannot assert against the beneficiary defenses it may have against its customer, the beneficiary should not qualify as a third party beneficiary of the contract between the customer and issuer. Thus, the issuer’s obligations to a beneficiary are statutory, not contractual, thereby precluding a contract action.

2. In Certain Circumstances, a Tort Cause of Action Should Be Permitted

Although the Code displaces a contract claim, an issuer may nevertheless be liable to the beneficiary in tort. Section 5-115 arguably prescribes the beneficiary’s sole remedy for wrongful dishonor, but that does not mean that wrongful dishonor is the beneficiary’s only cause of action. Potential tort causes of action could include fraud, civil conspiracy, and

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77. If the issuer anticipatorily repudiates the credit and the beneficiary learns of the repudiation before procuring the documents, the beneficiary may use the anticipatory repudiation remedy of a seller in § 2-610. See id. § 5-115(2). “Otherwise the beneficiary has an immediate right of action for wrongful dishonor.” Id.

78. It is the customer who contracts with the issuer for the issuance of the credit. See supra note 10 and infra note 109 and accompanying text. Offer and acceptance are necessary to form a contract. See J. Calamari & J. Perillo, supra note 39, § 2-1, at 22-23.

79. U.C.C. § 5-105 (1977). It is not expected that a bank would issue a credit without remuneration, but the beneficiary is not expected to know the amount or to prove such remuneration. "Id. official comment.


81. See U.C.C. § 5-115 (1977) (provision gives remedy to beneficiary when issuer wrongfully dishonors); McLaughlin, supra note 48, at 6, col. 2. But see U.C.C. § 4-402 (1977) (“payor bank is liable to its customer for damages proximately caused by the wrongful dishonor;” liability is limited to actual damages if dishonor caused through mistake). The two sections are not cross-referenced, however. Therefore, the fact that § 5-115 does not explicitly provide for consequential damages does not necessarily mean they should not be permitted.

82. McLaughlin, supra note 48, at 6, col. 2.

83. A plaintiff claiming a deceit cause of action must prove that a false representation was made knowingly, or without belief in its truth, or recklessly with respect to its truth. See Prosser and Keeton, supra note 1, § 107, at 740.

84. See id. § 46, at 324 for a discussion of the elements of this tort.
or prima facie tort.\textsuperscript{85} Tortious conduct necessarily consists of more than mere wrongful dishonor.\textsuperscript{86} Depending on the particular tort theory and the conduct of the bank, the tort cause of action may not thwart the Code's policy. If tort liability would not thwart the policy of the Code, courts should permit it if the beneficiary can otherwise establish the claim.

Concededly, tort claims predicated on wrongful dishonor may threaten the element of certainty that makes letters of credit commercially desirable.\textsuperscript{87} In issuing a letter, the bank may assume that its liability is limited to the face amount of the letter.\textsuperscript{88} Tort liability potentially undermines this expectation, thus introducing an element of uncertainty from the bank's perspective.\textsuperscript{89} Nevertheless, possible tort liability may discourage issuers from wrongfully dishonoring, thereby enhancing the beneficiary's certainty of payment.

Any time the bank decides to dishonor, it is deliberately not paying. Every instance of wrongful dishonor could therefore give rise to potential tort liability; wrongful dishonor should only subject the issuer to section 5-115 liability.\textsuperscript{90} Otherwise, the bank would be taking an unforeseeable risk in issuing the letter of credit. When the bank's conduct consists of more than just wrongful dishonor, however, imposing tort liability does not frustrate the bank's reasonable expectations. If the beneficiary can prove that the issuer and customer conspired not to pay the beneficiary, the issuer may be liable for the tort of civil conspiracy.\textsuperscript{91} When the bank willfully violates its duty of good faith under the letter, tort liability in excess of the face amount of the letter is reasonably foreseeable. In such cases, the beneficiary's cause of action should not be limited to section 5-115.

Because banks could readily abuse the informal procedures employed in deciding whether to honor the beneficiary's demand,\textsuperscript{93} tort liability

\begin{itemize}
\item \textsuperscript{85} See \textit{id.} § 130, at 1010-11 for a description of this tort.
\item \textsuperscript{86} In order to sue in tort as well as for wrongful dishonor, the beneficiary would have to prove the elements of a tort claim, as well as a breach of the issuer's duties under the Code.
\item \textsuperscript{87} See H. Harfield, \textit{supra} note 6, at 108-09.
\item \textsuperscript{88} See \textit{supra} notes 74-76 and accompanying text.
\item \textsuperscript{89} See H. Harfield, \textit{supra} note 6, at 108-09.
\item \textsuperscript{90} Clearly, the issuer should not be subject to tort liability every time it wrongfully dishonors. Otherwise, the Code remedy could always be sidestepped. The act of wrongful dishonor would constitute only one of several elements required to establish a valid tort claim. See \textit{supra} note 86.
\item \textsuperscript{92} See U.C.C. § 5-109(1) (1977).
\item \textsuperscript{93} The issuer may be subject to a "cross-fire of pressures." J. White & R. Summers, \textit{supra} note 6, § 18-6, at 731-32 (quoting T. Schlesinger Study, State of N.Y. Law Revision Comm'n Study of Uniform Commercial Code: Article 5—Documentary Letters of Credit, 3 N.Y. State Law Revision Comm'n, 1955 Report, at 1634-35); see Bank of Cochin Ltd. \textit{v.} Manufacturers Hanover Trust Co., No. 83 Civ. 1767, slip op. at 11-12 (S.D.N.Y. July 9, 1985); B. Clark, The Law of Bank Deposits, Collections and Credit
may be particularly appropriate. If the bank decides the beneficiary’s documents do not strictly conform, it must formally notify or return the draft to the beneficiary\(^9\) in order to give him a chance to correct the problem. In the interest of convenience, however, the issuing bank may informally ask its customer to waive the nonconformity.\(^9\) If the customer does so, the issuer will honor the demand without requiring the beneficiary to revise the nonconforming documents. Although this informal procedure generally serves the interests of all the parties, the issuer's allegiance to the customer may translate into collusion. Rather than merely notifying the customer that it intends to dishonor unless the customer waives the discrepancies, the issuer may solicit the customer's advice in deciding whether to dishonor. In doing so, the issuer surrenders its independence to the customer's interests, thereby flouting its fundamental duty under the Code.\(^9\)

The availability of a tort action, such as fraud\(^9\) or civil conspiracy,\(^9\) may deter improper communication between customer and issuer.\(^9\) The bank will probably monitor its employees more carefully to prevent improper communication. Consequently, allowing the beneficiary to sue in tort for this type of issuer malfeasance does not thwart the purposes of the Code.

This situation is less likely to occur, however, when the beneficiary presents the documents to a confirming bank. The beneficiary typically requests a confirming bank in his geographic area when he is unfamiliar with the issuing bank.\(^10\) The confirming bank therefore has ties to the beneficiary and not to the customer. If the conspiracy scenario does arise, however, a tort action should be available because a confirming

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\(^9\) Cards § 8.5[4], at 8-48 (1981). For example, the customer may insist on dishonor for microscopic discrepancies, particularly if the price of the underlying goods has dropped since the time of the contract, while the beneficiary may threaten to sue for wrongful dishonor. *See Bank of Cochin Ltd.*, slip op. at 11-12; B. Clark, *supra*, § 8.5[4], at 8-48; J. White & R. Summers, *supra* note 6, § 18-6, at 731-32 (quoting Schlesinger Study, State of N.Y. Law Revision Comm’n, Study of Uniform Commercial Code: Article 5-Documentary Letters of Credit, 3 N.Y. State Law Revision Comm’n, 1955 Report, at 1634-35).


\(^9^5\) The beneficiary is spared the time and inconvenience of curing the documents. The customer waives the noncompliance if it is immaterial, and receives title to the goods sooner. The issuer fulfills its function under the Code yet saves the time of checking the beneficiary's second demand.

\(^9^6\) The issuer's obligation to examine the conformity of the documents independent of any underlying agreements makes the letter of credit commercially useful. *See Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co.*, No. 83 Civ. 1767, slip op. at 8 (S.D.N.Y. July 9, 1985); Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 357, 336 A.2d 316, 323 (1975); Justice, *supra* note 8, at 426-27.

\(^9^7\) See supra note 83.

\(^9^8\) See Prosser and Keeton, *supra* note 6, § 46, at 324.

\(^9^9\) Without the potential for tort liability, the risk of collusion to the bank is no greater than the risk of mere wrongful dishonor.

bank assumes the rights and obligations of an issuer. 101

Another situation justifying tort liability arises when the customer's financial problems cause the issuer to subordinate its duty to the beneficiary to its own interests. If the customer goes bankrupt before the issuer pays the beneficiary, the issuer may fear it will not be reimbursed by the customer. Accordingly, the issuer may exaggerate any discrepancies in the documents presented by the beneficiary and refuse to pay. 102 This conduct undermines the essence of the letter of credit. 103 If the beneficiary can prove the issuer's bad faith in dishonoring, tort liability is appropriate because it may discourage banks from wrongfully dishonoring in bad faith, 104 thus promoting the policies of Article 5. 105

This situation is also unlikely to occur with a confirming bank. 106 The confirming bank receives its reimbursement from its customer, the issuing bank, which is less likely to become insolvent than a merchant. 107 If the situation does occur, however, the same analysis favors permitting the beneficiary to sue in tort.

B. Customer v. Issuer

The issuer owes the customer statutory duties of acting in good faith and examining the documents with care, 108 as well as common law con-

102. The beneficiary's initial documents often contain discrepancies. See Leichter & Harnik, Strict Compliance Seen Deterring Reliability of Letters of Credit, N.Y.L.J., Sept. 10, 1983, at 5, col. 1, at 6, col. 3, n.20 (citing Marine Midland Bank Study that found that 40% of initial presentations contained discrepancies); McLaughlin, supra note 48, at 6, col. 4.
103. The independent obligation of the bank to examine the documents regardless of the underlying facts makes the letter of credit commercially useful. See supra notes 63-67 and accompanying text. In searching for a reason to dishonor, the issuer is not serving its function of a neutral observer. Because first presentments often contain discrepancies, see supra note 102, the issuer will often be able to point to a nonconformity as a reason for dishonor, even if that nonconformity would not normally give rise to dishonor under a strict compliance standard. A strict compliance standard requires less conformity than a literal compliance standard. See supra note 61 and accompanying text.
104. See supra notes 91-99 and accompanying text.
105. The underlying policy of Article 5 is to promote the use of letters of credit. See supra notes 56-58 and accompanying text. The primary reason letters of credit work so well is due to the function of the neutral bank with reputable solvency. See infra note 107.
106. See supra notes 100-01 and accompanying text.
107. Because of the seller's distrust of the buyer's creditworthiness, the letter of credit essentially substitutes the issuer's credit for the buyer's credit. See, e.g., Insurance Co. of N. Am. v. Heritage Bank, N.A., 595 F.2d 171, 173 (3d Cir. 1979) (per curiam); H. Ray Baker, Inc. v. Associated Banking Corp., 592 F.2d 550, 552-53 (9th Cir.), cert. denied, 444 U.S. 832 (1979); Courtaulds N. Am., Inc. v. North Carolina Nat'l Bank, 387 F. Supp. 92, 98 (M.D.N.C.), rev'd on other grounds, 528 F.2d 802 (4th Cir. 1975); H. Harfield, supra note 6, at 27, 44.
108. U.C.C. §§ 5-109(1)-(2) (1977); see also id. § 5-114(2)(b) (issuer honoring in good faith may honor demand despite notification).
tractual duties.\textsuperscript{109} Article 5, however, is silent with respect to the customer's remedies if the issuer wrongfully honors or dishonors.\textsuperscript{110} When the Code expressly establishes a duty but prescribes no remedy for its violation, common law remedies apply.\textsuperscript{111} Thus, the violation of a Code duty may also give rise to common law liability for which punitive damages are permitted. In that case, if the Code does not displace the common law claim, punitive damages are theoretically available for wrongful honor.

1. A Common Law Contract Cause of Action Applies

The issuer owes the customer contractual duties.\textsuperscript{112} To obtain the letter of credit, the customer agrees to reimburse the issuer for amounts paid under the letter.\textsuperscript{113} When the letter is issued, it becomes the contract between the issuer and the customer.\textsuperscript{114} The issuer's liability is thus based on contract and is governed by common law,\textsuperscript{115} but with whatever limits the UCC may impose.

If the issuer improperly pays on a draft, either because the documents do not conform or the issuer knowingly accepts false or fraudulent documents, the issuer breaches both the reimbursement contract and the obligations imposed by section 5-109(2), which are incorporated into the contract.\textsuperscript{116} Because the Code imposes obligations\textsuperscript{117} without specifying a remedy, allowing common law remedies provides the customer with a

\begin{itemize}
\item \textsuperscript{109} See H. Harfield, \textit{supra} note 6, at 103; J. White & R. Summers, \textit{supra} note 6, § 18-7, at 741.
\item \textsuperscript{110} See U.C.C. § 5-109 (1977); J. White & R. Summers, \textit{supra} note 6, § 18-7, at 741.
\item \textsuperscript{111} See U.C.C. § 1-106(2) (1977) ("Any right or obligation declared by [the UCC] is enforceable by action unless the provision declaring it specifies a different and limited effect."); \textit{accord id.} official comment 2 (any right or obligation in Code is enforceable by court action even though remedy not expressly provided, unless provision states limited effect).
\item \textsuperscript{112} See \textit{supra} note 109 and accompanying text. These contractual duties incorporate the standard of care of U.C.C. § 5-109(2) (1977). See J. White & R. Summers, \textit{supra} note 6, § 18-7, at 741.
\item \textsuperscript{113} Generally, the reimbursement agreement between the issuer and customer states that the issuer will issue the letter of credit and the customer will reimburse the issuer for payments made to the beneficiary pursuant to the letter. Even if the contract does not discuss reimbursement, the issuer is statutorily entitled to reimbursement, conditioned on the issuer's "duly" honoring the draft. U.C.C. § 5-114(3) (1977); \textit{accord U.C.P. art. 8}; H. Harfield, \textit{supra} note 6, at 49-50. An issuer loses its right of reimbursement if the documents do not facially conform or if it acts in bad faith. See Chase Manhattan Bank v. Equibank, 550 F.2d 882, 886 (3d Cir. 1977) (if issuing bank pays beneficiary despite noncompliance, issuer jeopardizes its right to reimbursement from customer); Consolidated Aluminum Corp. v. Bank of Va., 544 F. Supp. 386, 389 n.9 (D. Md. 1982) (same), \textit{aff'd}, 704 F.2d 136 (4th Cir. 1983).
\item \textsuperscript{114} See \textit{supra} note 109 and accompanying text.
\item \textsuperscript{115} See \textit{supra} note 109 and accompanying text.
\item \textsuperscript{116} See \textit{supra} note 112. It is important to note, however, that if the beneficiary skillfully forged the documents so that they facially conformed, the customer can only sue the beneficiary on the underlying agreement and would have no claim against the issuer. See \textit{supra} note 59.
\item \textsuperscript{117} See U.C.C. § 5-109 (1977). See \textit{supra} notes 108-10 and accompanying text.
\end{itemize}
means of enforcing the issuer's obligations. Encouraging the issuer to act in good faith enhances Code policies. Therefore, a breach of contract action should not be displaced by the Code.

Moreover, the Code provides that Article 5 does not contain all the rules governing letters of credit. Because the customer and issuer have a contract and the UCC does not specify a remedy, common law contract remedies should apply. Accordingly, if the jurisdiction permits punitive damages in connection with a contract action, they are theoretically available to the customer under the Code.

2. Independent Tort Liability Is Unlikely But Permissible

Similarly, because the Code is silent concerning remedies for violation of duties owed to the customer, any applicable tort causes of action are not displaced. As a practical manner, however, the issuing bank is unlikely to incur tort liability in a wrongful honor situation. The issuer probably has no motive to improperly pay the beneficiary. Not only is the beneficiary likely to be unknown to the issuer, but the issuer would lose its right to reimbursement from the customer.

Additionally, the issuing bank cannot be held liable in tort for mere wrongful honor. In such a case, the customer should be limited to a breach of contract cause of action. Otherwise, every wrongful honor would potentially subject the issuer to tort liability. Furthermore, the customer could not credibly claim that the issuer was negligent in not discovering fraud underlying the documents. The issuer's obligations

118. See supra notes 108-11 and accompanying text.
120. The Code only displaces a common law cause of action if common law would thwart the Code's policies. See supra notes 49-55 and accompanying text.
121. See U.C.C. § 5-102(3) & official comment 2 (1977).
122. See supra note 109 and accompanying text.
123. See supra notes 112-22, 124-44 and accompanying text.
124. See supra notes 108-11 and accompanying text.
125. The customer contracts with the issuer, not the beneficiary. See supra note 109 and accompanying text.
126. See supra note 113 and accompanying text.
127. The issuer is immune from liability for the underlying transaction because it lacks
to the customer do not include a duty to verify the facts represented in the documents.\textsuperscript{128} If the issuer does commit fraud, however, the customer should have a claim in tort.

Accordingly, any applicable common law causes of action are available to the customer when the issuer breaches a duty imposed by the Code. If punitive damages are allowed under the particular substantive claim, the Code should not preclude their availability unless punitive damages would independently thwart Code policy.

C. Customer v. Confirming Bank

1. No Common Law Contract Cause of Action Exists

Section 5-109 establishes the confirmor’s duties to its customer,\textsuperscript{129} the issuer, but the Code does not specify any duties owed to the ultimate customer.\textsuperscript{130} The customer does not have a common law contract cause of action because it lacks privity with the confirming bank.\textsuperscript{131} The con-

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\textsuperscript{128} See supra notes 59-63 and accompanying text, and supra note 119.

\textsuperscript{129} See supra notes 59-61.

\textsuperscript{129} See U.C.C. §§ 5-107(2), -109 (1977). Because the confirmor assumes the issuer’s duties, id. § 5-107(2), § 5-109 states the confirmor’s obligations—good faith and observance of general banking custom to its customer—as well as the issuer’s duty to examine the documents “with care” in determining facial conformity. See id. § 5-109(2).

\textsuperscript{130} Courts have interpreted the confirmor’s duties as running only to its customer, the issuer, and not to the ultimate customer. See Instituto Nacional De Comercializacion Agricola (Indeca) v. Continental Ill. Nat’l Bank & Trust Co., 530 F. Supp. 279, 282-85 (N.D. Ill. 1982); Dulien Steel Prods., Inc. v. Bankers Trust Co., 189 F. Supp. 922, 929 (S.D.N.Y. 1960) (dictum), aff’d, 298 F.2d 836 (2d Cir. 1962); Linden v. National City Bank, 12 A.D.2d 69, 70, 208 N.Y.S.2d 182, 184 (1960). But see Confirming Bank Liability, supra note 100, at 1236-43 (advocating extension of Code provisions by analogy and doing away with the privity requirement).

The definition of “customer” in Article 5 also includes an issuing bank that procures a confirmation on behalf of its customer. U.C.C. § 5-103(g) (1977). Because § 5-109 speaks of the issuer’s duties to its customer, and the confirmor assumes the obligations of its issuer, and the confirmor’s customer is the issuer under the Article 5 definition, the § 5-109 duties run toward the confirmor’s customer. The issuer contracts with the confirming bank. The confirming bank relies on the credit of the issuer, not that of the ultimate customer. See Kunglig Jarnvagsstyrelsen v. National City Bank, 20 F.2d 307, 309 (2d Cir.), cert. denied, 275 U.S. 497 (1927); Instituto Nacional de Comercializacion Agricola (Indeca) v. Continental Ill. Nat’l Bank & Trust Co., 530 F. Supp. 279, 283 (N.D. Ill. 1982). The confirmor receives reimbursement solely from the issuer. See Kunglig Jarnvagsstyrelsen, 20 F.2d at 309; Instituto Nacional de Comercializacion Agricola (Indeca), 530 F. Supp. at 283; Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp., 245 N.Y. 377, 382, 157 N.E. 272, 274 (1927).


In pre-Code cases, courts also denied the customer a contract cause of action for lack of privity. See Oelbermann v. National City Bank, 79 F.2d 534, 535, 537 (2d Cir. 1935), modified per curiam, 298 U.S. 638 (1936); Kunglig Jarnvagsstyrelsen v. National City
firming bank has contracted solely with the initial issuer.\textsuperscript{132} The confirmer's obligations under the Code,\textsuperscript{133} like those of the original issuer, are independent of the other transactions underlying the letter of credit,\textsuperscript{134} including the contract between the customer and issuer.

2. In Certain Limited Situations, a Tort Cause of Action Should Be Permitted

Although the confirmer's duty generally runs only to the issuer,\textsuperscript{135} these duties should occasionally be construed to run to the customer. It is possible that the confirming bank can breach its duty of care in examining the documents without the issuer breaching its duty in honoring the draft. This situation occurs if the beneficiary fraudulently obtains the "conforming" documents, and the confirmer honors with knowledge, either constructive or actual, of the fraud. If the documents appear to conform when the issuer receives them from the confirmer, the issuer rightfully reimburses the confirmer, and the customer is required to reimburse the issuer.\textsuperscript{136} The issuer has little incentive to sue the confirmer because it has already received payment from the customer. Thus, the issuer's independent duty to inspect documents for facial conformity\textsuperscript{137} does not protect the customer from collusion between the confirming bank and the beneficiary. Because the beneficiary selects the confirmer, with whom it typically has an ongoing relationship,\textsuperscript{138} there is a risk of collusion.\textsuperscript{139} In this situation, therefore, the confirming bank's duties

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\textsuperscript{132} See supra note 131 and accompanying text.

\textsuperscript{133} U.C.C. §§ 5-107(2), -109 (1977).

\textsuperscript{134} Since the confirming bank becomes "directly obligated on the credit . . . as though it were its issuer," U.C.C. § 5-107(2) (1978), the independence principle also applies to the confirming bank's obligation. See Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp., 216 A.D. 495, 498, 215 N.Y.S. 525, 528-29 (1926), aff'd, 245 N.Y. 377, 157 N.E. 272 (1927).


\textsuperscript{136} The issuer, as the confirming bank's customer, must reimburse the confirming bank for amounts paid on the letter if the documents facially conform. See U.C.C. § 5-114(3) (1977).

\textsuperscript{137} See supra note 12 and accompanying text.

\textsuperscript{138} Bank of Cochin Ltd. v. Manufacturers Hanover Trust Co., No. 83 Civ. 1767, slip op. at 13-14 (S.D.N.Y. July 9, 1985).

\textsuperscript{139} See Bank of Newport v. First Nat'l Bank & Trust Co., 687 F.2d 1257, 1264-65 (8th Cir. 1982) (issuer did not have to honor draft presented by assignee bank because bank knew the terms of the letter were not complied with and had contributed in preventing the underlying contract from being performed); Instituto Nacional de Comercializa-
should occasionally be construed to run to the customer, and the confirmer should be liable in tort to the customer for violating these duties.

Allowing the customer to sue the confirmer in tort does not thwart the purposes of Article 5. Indeed, because it provides the customer with a remedy against the otherwise immune confirmer, it enhances the customer's interest in using letters of credit. Since confirming banks allowed Agricola (Indeca) v. Continental Ill. Nat'l Bank & Trust Co., 530 F. Supp. 279, 281-82 (N.D. Ill. 1982) (confirming bank knew or should have known the beneficiary's documents were forged); Confirming Bank Liability, supra note 100, at 1230-31 (confirming bank often closely allied with beneficiary).

140. In Instituto Nacional de Comercializacion Agricola (Indeca) v. Continental Ill. Nat'l Bank & Trust Co., 530 F. Supp. 279 (N.D. Ill. 1982), the court held that while a confirming bank could not be held liable to the issuing bank's customer in contract, the customer could sue in tort under certain circumstances. Id. at 284-85. The beneficiary had presented the Chicago confirmer with a certificate of origin lacking the necessary legalization from the Guatemalan Consulate in Miami, Florida. Id. at 281. Later that afternoon, the beneficiary reappeared with an allegedly legalized certificate. Id. at 281-82. The confirmer paid the beneficiary and sent the documents to the issuer. Id. at 280. The documents were in fact forged, and the goods were never sent to Guatemala. Id. at 280-81. The court stated that in these circumstances, only the confirming bank could have discovered the beneficiary's fraud. Id. at 284-85.

At least one commentator severely criticized this decision. See, e.g., Farrar, Letters of Credit, 38 Bus. Law. 1169, 1176-77 (1983); Farrar, supra note 25, at 420-21. The primary focus of the commentator's concern was that the court required the confirming bank to go beyond determining mere facial conformity of the presented documents. See, e.g., Farrar, supra, at 1176-78 (1983); Farrar, supra note 25, at 420-21. As a result, the commentator concluded that imposing liability in that situation violated a governing principle of letter of credit law. See id. The Fifth Circuit also criticized Indeca in Auto Servicio San Ignacio v. Compania Anonima Venezolana de Navegacion, 765 F.2d 1306, 1308-09 (5th Cir. 1985).

In Auto Servicio, the customer sued the confirming bank for negligently examining the documents. Id. at 1308. The court granted summary judgment in favor of the defendant because it interpreted the duty of the confirming bank as running only to the issuer. The court stated that expanding this liability through tort principles violates the Code's intent. Id. The court gave two policy reasons for its decision. First, allowing the application of tort liability would inject uncertainty into letters of credit. Id. This would disrupt the transaction and is implicitly rejected by the Code. Id. Second, if confirming banks are held liable to the customer, a party with whom it had never dealt, banks would be discouraged from confirming a letter. Id. The court distinguished Indeca on the ground that it involved a tort claim for negligently supervising the revision of documents, while Auto Servicio involved a tort claim for negligently examining the documents. Id. at 1308-09.

This distinction is unpersuasive and does not justify different policy decisions. Examining the revised documents is part of the confirmer's duty to examine the documents with care and good faith. See U.C.C. § 5-107 (1977) (confirmer assumes obligations of issuer); id. § 5-109 (issuer must examine documents with care and in good faith). Although the duties owed in Indeca and Auto Servicio are essentially indistinguishable, the result in Auto Servicio is nevertheless correct on its facts. The confirmer in Auto Servicio was merely negligent, but did not breach its duties under the Code. Permitting a mere negligence cause of action would require a confirmer to go far beyond its proper function.

Despite the correct result, the Fifth Circuit's holding that a customer never has a direct cause of action against the confirmer is too broad. In light of the policy enunciated in Article 1, see supra notes 50-55 and accompanying text, such a cause of action should be permitted in certain limited situations. In Indeca, the court indicated that the confirmer did violate its duty of good faith under the Code. Because the confirmer presumably
ready owe the issuer a duty of examining the documents with care and good faith, permitting the customer to sue in tort imposes no additional obligations on the confirming bank. It merely permits another party to enforce the confirmer's existing obligations when the confirmer would otherwise be shielded from liability. Because the customer is the party ultimately harmed by violation of the confirmer's duties, the customer should be entitled to enforce their performance. Without a remedy, he may be discouraged from seeking the letter of credit and many potential transactions may not occur.

Moreover, Article 7 of the Uniform Customs and Practice for Documentary Credits (UCP)\(^\text{4}\) defines the duties of banks, but does not state to whom these duties are owed.\(^\text{1}4^2\) However, Article 12(a) states "[b]anks [using] the services of another bank for the purpose of giving effect to the instructions of the applicant for the credit do so for the account and at the risk of the latter."\(^\text{1}4^3\) This language reflects a recognition that the confirming bank performs its duties for the customer's protection. Thus, tort liability for harm to the customer does not frustrate the confirmer's reasonable expectations.\(^\text{1}4^4\)

As noted earlier, there may be situations in which the customer has no recourse against the issuer for the confirmer's wrongful conduct because the issuer properly performed its obligation. In these situations, allowing a tort action against the confirmer reinforces the expectations of the parties to the letter, thereby promoting its use. If courts do not permit the customer a direct cause of action, the confirming bank is essentially immune from liability. The customer would have to absorb the cost of the confirming bank's bad faith, thereby decreasing the efficiency of letters of credit. Moreover, denying the customer an action frustrates Code policy by opening a loophole that may encourage fraudulent conduct. Permitting a tort claim under these circumstances merely closes a gap left by the Code without increasing the legal burden or economic risk undertaken by the confirming bank.

\(^{141}\) U.C.P. art. 7 states:

Banks must examine all documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in accordance with the terms and conditions of the credit.


\(^{143}\) U.C.P. art. 12.

\(^{144}\) See Confirming Bank Liability, supra note 100, at 1230-31.
Even if the Code permits these common law causes of action, however, the availability of punitive damages may nevertheless thwart the purposes of the Code. If so, the Code displaces a punitive damage remedy. 145

II. DESPITE CREATING SOME UNCERTAINTY, PUNITIVE DAMAGES SHOULD BE AVAILABLE IN LIMITED SITUATIONS

Because Article 5 neither specifically authorizes nor prohibits punitive damages, 146 the possibility of punitive liability arises in letter of credit litigation only if the applicable state law permits them in a business tort context. 147 As noted earlier, many courts and commentators have stated that punitive liability should not be permitted for business misconduct, especially when the injury is purely economic. 148 Nevertheless, assuming that the state whose law governs the action has decided to permit punitive damages, they should be available in letter of credit litigation as long as punitive liability would not undermine the letter's commercial utility. 149

A. PUNITIVE DAMAGES CREATE SOME UNCERTAINTY IN LETTERS OF CREDIT

The availability of punitive damages may inject uncertainty into letter of credit transactions, which rest on objective standards governing clearly defined expectations and risks. 150 Punitive damage liability is inherently unpredictable. The amount of punitive damages is within the jury's discretion. 151 Moreover, a plaintiff's attorney may disproportionately influence a jury by appealing to its prejudices against powerful corporate institutions. 152 Additionally, the plaintiff may present evidence of

145. See supra notes 44-58 and accompanying text.
146. See supra note 30 and accompanying text.
147. See supra note 36 and accompanying text.
148. See supra notes 2-4 and accompanying text.
149. See supra note 30 and accompanying text.
150. See supra note 8 and accompanying text.
152. See Coffee, Making the Punishment Fit the Corporation: The Problems of Finding an Optimal Corporation Criminal Sanction, 1 N. Ill. U.L. Rev. 3, 20 (1980). Banks may be particularly susceptible to such prejudice. In Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399 (1st Cir. 1985), the customer's attorney successfully argued in trial court for the jury to send a message to that [Hospital Trust] Board of Directors across the street. . . . Send the message to other banks in Rhode Island, and indeed, the world because this case will be reported inevitably . . . . If you don't stop this type of conduct right now, not only for [the plaintiff], but for the lady in Westerly and the guy in Woonsocket, if you don't stop it, who will? Id. at 410-11; see Owen, Problems in Assessing Punitive Damages Against Manufacturers of Defective Products, 49 U. Chi. L. Rev. 1, 11 (1982); Werner, Management, Stock Market and Corporate Reform: Berle and Means Reconsidered, 77 Colum. L. Rev. 388, 390 (1977); The Insurability of Punitive Damages, supra note 2, at 1388-91.
defendant's wealth on the issue of the amount of punitive damages, defendant's wealth on the issue of the amount of punitive damages, thereby further prejudicing the jury against the bank. Furthermore, many states do not require the punitive amount to bear any relation to the compensatory amount. Finally, the vague standards for assessing punitive damages—conduct that is wanton, gross, outrageous or reckless—also contribute to their unpredictability.

Any assessment of punitive damages against the issuer may be unfair in light of the legal understandings and expectations of the parties entering a letter of credit agreement. The minimal fee charged by the issuer reflects a commercial understanding that it assumes a minimal obligation and a commensurately low risk. This uncertainty makes it very difficult to incorporate accurately the risk of punitive damages into the economic decision to issue a letter of credit. The issuer's obligation is simple and essentially nondiscretionary: to determine whether the documents presented by the beneficiary "strictly" conform to the terms of the letter, a lesser standard than literal compliance. The potential for punitive damage liability in connection with low cost, ministerial functions may discourage banks from issuing letters of credit. Alternatively, banks may seek a cushion by charging higher prices for their services. Theoretically, letters of credit could be priced out of the commercial financing market. In either case, two of the primary reasons underlying the letter's commercial usefulness, the ease and low cost of establishing the letter, could be undermined.


154. See DuBois, Punitive Damages in Personal Injury, Products Liability and Professional Malpractice Cases: Bonanza or Disaster, 43 Ins. Couns. J. 344, 351 (1976); Insurability of Punitive Damages, supra note 2, at 1390 & n.40.


159. See supra notes 59-62 and accompanying text.
B. Despite Uncertainty, Punitive Damages Do Not Thwart Letter of Credit Use

While these concerns undeniably influence any proper interpretation of Code policy, the limited potential for punitive liability in letter of credit disputes diminishes the relevance of economic reasoning to this particular question. Because punitive damage awards would be rare, their availability should neither discourage banks from issuing letters nor encourage them to raise fees appreciably.

Tortious conduct alone does not result in an award of punitive damages. To justify punitive damages, a bank must have acted outrageously. Most banks, however, would not rationally engage in conduct that would justify a punitive damage award because preserving their reputation for commercial honor significantly contributes to the marketability of services such as the letter of credit. Since the Code already insulates most exercises of discretion by the issuer in determining whether to honor a letter of credit, only an intentional breach of the minimal duties assumed by the bank would justify an award of punitive damages.

Moreover, fears that the availability of punitive damages for business misconduct may chill economic activity, such as letter of credit financing, are probably exaggerated. Although not many quantitative studies concerning punitive damages exist, one recent study indicates that, contrary to general belief, juries do not routinely award punitive damages.


161. See supra note 1 and accompanying text.

162. See H. Harfield, supra note 6, at 111. Banks generally have a high interest in maintaining their commercial honor. The Iranian letter of credit cases illustrate this. Many American companies had contracts with the government of Iran when the Shah was in power. American banks issued standby letters of credit to pay if the companies defaulted on their services as judged by the Iranian Ministry of War. When the Ayatollah Khomeini took power, the Ministry claimed that these companies had defaulted on their performance and submitted the required documents to the American banks. Despite intense political pressure, the banks planned to pay until courts began issuing injunctions. See, e.g., KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 12 (2d Cir. 1979); Itek Corp. v. First Nat'l Bank, 511 F. Supp. 1341, 1342-43, 1352 (D. Mass. 1981), aff'd, 730 F.2d 19, 28 (2d Cir. 1982); American Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420, 421, 427 (S.D.N.Y. 1979); United Technologies Corp. v. Citibank, N.A., 469 F. Supp. 473, 475 (S.D.N.Y. 1979); Stromberg-Carlson Corp. v. Bank Melli Iran, 467 F. Supp. 530, 531-33 (S.D.N.Y. 1979).

163. See supra notes 59-64 and accompanying text.

The mere availability of punitive damages does not threaten ordinary use of letters of credit because punitive liability arises only in extraordinary situations involving commercially unjustifiable conduct.\textsuperscript{165} Although the availability of punitive damages creates uncertainty from the bank's perspective, the possibility of obtaining insurance against punitive damages substantially reduces the bank's uncertainty.\textsuperscript{166} In issuing an insurance policy with fixed premiums, the insurance company assumes the risk of an unforeseeable punitive damage award. Thus, the bank need only incorporate the cost of the insurance into its decision to issue the letter of credit. Because these increased costs would be diffused among all of the bank's letter of credit customers, the increase in price per letter should be minimal. Moreover, insurance premiums should be relatively low because the likelihood of punitive damages in letter of credit disputes is small.\textsuperscript{168} Furthermore, the availability of insurance will not lessen the deterrent value of punitive damages.\textsuperscript{169}

C. Punitive Damages May Actually Promote UCC Policies in Some Situations

Not only would the availability of punitive damages not necessarily impede the growth of letters of credit, it may even promote Code policies in certain circumstances. Making the beneficiary the stakeholder is an important function of the letter of credit.\textsuperscript{170} Yet, Article 5 probably displaces consequential damages as a tort remedy in actions involving wrongful dishonor.\textsuperscript{171} Thus, the potential for punitive liability may enhance the beneficiary's certainty of payment by possibly deterring unscrupulous banks from wilfully dishonoring.\textsuperscript{172} Similarly, the availability

\textsuperscript{165} An American Bar Foundation study not yet completed seems to conclude that prior discussion of problems and crises in punitive damages is based upon the "mega-cases," which are not typical. See Strasser, supra note 164, at 15. Juries tend to award punitive damages only in lawsuits involving near-criminal behavior, where such damages were intended. Id. at col. 2.

\textsuperscript{166} Although an egregious case is rare, it still may occur. When the bank's concern with its reputation does not provide enough deterrence, punitive damages should be applied. See Emery-Waterhouse Co. v. Rhode Island Hosp. Trust Nat'l Bank, 757 F.2d 399, 408 (1st Cir. 1985). See infra Part II.C.

\textsuperscript{167} There is a trend toward the insurability of damages. See Schumaier & McKinsey, The Insurability of Punitive Damages, 72 A.B.A. J., March 1, 1986, at 68. At least 29 jurisdictions allow insurability in cases of vicarious liability, while only 13 jurisdictions do not permit insurability as a matter of policy. Id. at col. 2.

\textsuperscript{168} See supra notes 160-66 and accompanying text.


\textsuperscript{170} See supra notes 20-21 and accompanying text.

\textsuperscript{171} See infra notes 178-80 and accompanying text.

\textsuperscript{172} The beneficiary requests a letter of credit primarily to obtain an assured payment method. See supra notes 7-8 and accompanying text.
of punitive damages may deter confirming banks from defrauding the customer, who also lacks the remedy of consequential damages in this situation.\textsuperscript{173}

Admittedly, evidence exists that the drafters of the Code may have intended to preclude the beneficiary from receiving any extracompensatory damages. The 1952 Official Text of the UCC stated that “in no event shall recovery exceed the amount of the credit or the draft as the case may be.”\textsuperscript{174} This language suggests that any extracompensatory recovery in a wrongful dishonor suit might violate Code policy.\textsuperscript{175} Although deleted from the ratified version of the Code, this clause remains relevant to the debate concerning punitive damages. Most evidence of the drafters' intent supports the conclusion that they deleted the clause primarily to permit the beneficiary to sue for interest on the face amount of the draft,\textsuperscript{176} thus arguably preserving a Code policy against exposing issuing banks to any extracompensatory damages. Nevertheless, the Code expressly acknowledges the possibility of punitive damages;\textsuperscript{177} section 1-106 merely limits punitive liability to claims governed by some "other rule of law."\textsuperscript{178}

In addition to punitive damages, potential tort liability also raises the possibility for an award of consequential damages. Although the issuer knows it is issuing the letter of credit in the beneficiary's favor, the amount of consequential damages could be unpredictable and certainly is not within the risk the issuer undertook in issuing the letter.\textsuperscript{179} Most importantly, the damages flowing from the underlying contract would

\textsuperscript{173} See infra notes 178, 184-85 and accompanying text.


\textsuperscript{175} By stating clearly that no extracompensatory damages would be permitted, this version of the Code may have intended to displace punitive damages in wrongful dishonor suits. See U.C.C. 1952 Official Draft in 15 E. Kelly, supra note 174, at 22.


\textsuperscript{177} See U.C.C. § 1-106 (1977).

\textsuperscript{178} See id.

\textsuperscript{179} See H. Harfield, supra note 6, at 108-09. In a customer-issuer suit, however, consequential damages are a possibility. Traditionally, if the issuer wrongfully honored, the customer merely had the right to refuse to reimburse the issuer or to force the issuer to return any prepayment or security the customer had paid. See H. Harfield, supra note 6, at 105-06. Because the customer and issuer have a common law contract, however, it may be reasonable to impose consequential damages against the bank, as long as the foreseeability requirements of contract law are met. See supra notes 112-15 and accompanying text. But see H. Harfield, supra note 6, at 108-09 (imposing consequential damages against the issuer would inject too much uncertainty into letters of credit); J. White & R. Summers, supra note 6, § 18-7, at 742-43 (the best customer could hope for would be damages for the entire amount of the draft). It is conceivable that even when an issuer wrongfully honors, the customer might suffer no consequential damages. See J. White & R. Summers, supra note 6, § 18-7, at 740-41. Possibly, the goods conformed with the underlying contract, even though the documents did not comply. Id. at 741.
determine the amount of consequential damages. Imposing consequential damages, therefore, violates the independence principle by extending the issuer's liability to circumstances necessarily beyond its contemplation.

Although consequential damages should not be permitted, that does not mean that the issuer should not be subject to punitive damages. Punitive damages are based on the bank's conduct with respect to the letter, not on the harm arising from nonperformance of the underlying sales contract. Thus, permitting punitive liability against issuing banks would not violate the independence principle.

Without consequential damages in tort, punitive damages may provide the only deterrent to fraud. The bankruptcy scenario illustrates the need for deterrence through punitive liability. If the customer becomes insolvent after the bank issues the letter but before it pays the beneficiary, the issuer has incentive to distort any trivial nonconformity in the beneficiary's documents as a pretense for dishonoring the draft. Without the possibility of punitive liability, the issuer would only be liable for the face amount of the letter plus incidental damages. Thus, the possibility of punitive damages may deter the bank from placing its self-interest ahead of its statutory duty to the beneficiary.

The absence of a consequential damages remedy in the customer-confirmer situation also demonstrates the need for the deterrent value of punitive damages. Because the beneficiary often selects the confirmer, with whom he may have an ongoing relationship, the customer rarely has any contact with the confirmer. Yet it is the confirming bank that inspects the documents and initially decides whether to honor the beneficiary's demand. As noted earlier, the issuer's incentive to protect the customer's interest is limited. Accordingly, this situation may present an opportunity for fraudulent collusion. Because a confirming bank that wilfully violates its duties under the Code undermines the commercial usefulness of the letter, punitive liability promotes use of the letter by providing the only credible deterrent against a conspiracy between the beneficiary and the confirming bank.

Of course, a bank's punitive liability would necessarily be vicarious. Critics contend that assessing punitive damages for vicarious liability penalizes persons who have done nothing wrong, and thus fails to deter wrongdoers effectively. Arguably, permitting punitive damages against the bank would not deter a bank officer from wrongfully ordering

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180. See supra note 12 and accompanying text.
181. See supra notes 90-105, 136-45 and accompanying text.
182. See supra notes 102-05 and accompanying text.
183. See supra notes 102-05 and accompanying text.
185. See supra notes 136-39 and accompanying text.
186. See supra notes 136-39 and accompanying text.
187. See supra notes 136-39 and accompanying text.
188. See Slain, Risk Distribution and Treble Damages: Insurance and Contribution, 45
the honor or dishonor of a draft. Nevertheless, if an officer’s misconduct causes the bank to pay punitive damages, the bank is likely to take action. Thus, assessing punitive damages against a bank may create an economic incentive to discipline reckless or corrupt employees, thereby potentially deterring such employees from engaging in fraud again. The possibility of punitive damages may encourage banks to improve their employee selection, monitoring and training procedures, thus reducing the likelihood that the letter of credit will be used as an instrument of fraud.

CONCLUSION

Although only a few courts have confronted the issue, more litigation concerning punitive damages is certain to occur. Because of the importance of letters of credit to modern commerce, and the importance of certainty to the letter of credit device, courts should be wary of applying common law liability and punitive damages. When analyzing section 1-106 of the Code, as modified by section 1-103, courts should apply common law liability only when the bank has violated its duties under the Code in addition to its common law duties. Additionally, punitive damages should only be available when the bank’s conduct is particularly egregious and needs to be deterred. Nevertheless, any time a bank wilfully acts in a manner that threatens the commercial viability of the letter of credit, punitive damages should be available to deter such conduct and to promote the use of this efficient financing device.

When the bank’s misconduct is not ordinary and “without commercial justification,” allowing punitive damages does not threaten the com-

N.Y.U. L. Rev. 263, 271-73 (1970); Insurability of Punitive Damages, supra note 2, at 1399.

189. One rationale for permitting punitive liability against corporations is that it may provide incentive for a company to more carefully select and supervise employees. See United States v. Hilton Hotels Corp., 467 F.2d 1000, 1005 (9th Cir. 1972), cert. denied, 409 U.S. 1125 (1973); Kline v. Multi-Media Cablevision, Inc., 233 Kan. 988, 992, 666 P.2d 711, 715 (1983); 2 G. Hornstein, Corporation Law and Practice § 564, at 36-37 (1959); Ellis, supra note 3, at 69; Fisse, Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions, 56 S. Cal. L. Rev. 1141, 1162 (1983); Insurability of Punitive Damages, supra note 2, at 1399. Other courts and commentators argue that it is practically and economically impossible to eliminate behavior that could lead to punitive damage liability. See Tolle v. Interstate Sys. Truck Lines, 42 Ill. App. 3d 771, 773, 356 N.E.2d 625, 627 (1976); Briner v. Hyslop, 337 N.W.2d 858, 865 (Iowa 1983); Slain, supra note 188, at 269; Insurability of Punitive Damages, supra note 2, at 1399. Punitive damages will probably deter senior managers and the board of directors because their professional reputations are connected with the procedures. Insurability of Punitive Damages, supra note 2, at 1401.


mmercial usefulness of letters of credit in everyday situations. Fraudulent banking practices are “not normal and . . . the law need not condone [them].”\textsuperscript{192}

\textit{Lisa G. Weinberg}

\textsuperscript{192} \textit{Id.}