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The Law of Letters of Credit

Publication 4822 Release 35 November 2024

HIGHLIGHTS

Release 35

- This release contains updates and revisions to provide the current status of the law, including developments in statutory, and regulatory law. The release includes discussion of several important recent developments and adds new and revised material on a number of significant topics.

As part of our regular updating, we have added coverage of recent letter of credit cases:

Performance guarantees. On-demand performance guarantees are analogous to letters of credit but are not equivalent to a letter of credit for all purposes. Like the letter of credit, commerce and the courts treat the on-demand performance guarantee as the equivalent of cash. When the demand complies with the guarantee's terms, the only two bases on which a guarantor can resist payment are by establishing the narrow grounds of either fraud or unconscionability. *TA Private Capital Security Agent Ltd. and another v. UD Trading Group Holding Pte Ltd*, [2024] SGHC 11. See § 1.05[2].

Autonomy principle. Although a Canadian court recognized that the essential characteristic of letters of credit is their autonomy from the underlying contract, this court also recognized that the autonomy principle may be impaired by an agreement between the applicant and the beneficiary. Case law supports the view that the beneficiary may be enjoined when the draw would violate a contractual obligation owed by the beneficiary. The applicant must raise a strong prima facie case to

obtain an injunction. The applicant's assertion of a verbal forbearance agreement regarding the standby credit did not raise a strong prima facie case. The court rejected the applicant's arguments based on the contractual duty of honest performance. However, the court granted an interim injunction that covered a holiday period when courts were closed so that the applicant could commence an appeal when the court re-opened. *Pacific Atlantic Pipeline Construction Ltd. v. Coastal Gaslink Pipeline Ltd*., 2023 ABKB 736. See § 1.06[1], § 7.04[5][j], § 11.05[4][b].

Scope of ISP98. An Australian court found that Chinese law applied to a standby credit governed by ISP98 that lacked a choice of law clause as this credit had stronger connections with China. The demand for payment was made by the beneficiary's receivers who made clear in the demand that they were acting as the beneficiary's representative. ISP98 Rule 6.11 regarding the transfer of the credit by operation of law was not enlivened. The beneficiary was a resident of Australia and the underlying contract was to be performed in Australia. But the credit's place of issuance was China and the demand had to be made in China. ISP98 Rule 1.08(d) provides that an issuer is not responsible for observing law or practice other than that chosen in the credit or applicable at the place of issuance. The place of performance of a credit is accorded significant weight. *Shinetec (Australia) Pty Ltd v. The Gosford Pty Ltd; The Gosford Pty Ltd v. Bank of China Ltd (No 2)* [2023] NSWSC 1405. See § 2.01, § 4.09[2], § 6.01.

A standby credit subject to ISP98 and New York law for matters not covered by ISP98, required a presentation that included the original credit and any amendments. Although ISP98 avoids the term "strict compliance," the Official Commentary notes that Rule 4.15(a) "begins with the presumption that an original is required unless the standby states otherwise." The beneficiary's presentation of a copy of the first amendment failed to comply with the credit's terms. The issuing bank refused to waive presentation of the original when contacted by the confirming bank. The failure to submit the original of the first amendment was fatal to the beneficiary's claim of wrongful dishonor. *Milky Whey, Inc. v. HSBC Bank USA, N.A.*, 2024 US Dist. LEXIS 61598 (SDNY Mar. 31, 2024). See § 4.09[2].

Choice of law. Under English law, the substantive characteristics of a letter of credit have important procedural implications that prevent the use of procedure to circumvent the beneficiary's substantive rights. A Swiss bank refused to pay on standby letters of credit that were governed by English law. Due to the Lugano Convention 2007, the beneficiary sued the Swiss bank in Switzerland. By filing a criminal complaint against its applicant-customer, the issuer obtained a stay on paying the beneficiary. There was a real risk that this stay could be in effect for years. The beneficiary commenced proceedings

in England. The courts of England and Wales were the most appropriate forum to address this dispute since the Swiss court failed to give effect to the substantive characteristics of the standby credits under English law. *Macquarie Bank Limited v. Banque Cantonale Vaudoise*, [2024] EWHC 114 (Comm.). See § 2.01, § 4.02.

Personal jurisdiction. A foreign buyer's purchase of Iowa agricultural products by its subsidiary did not make the foreign buyer subject to the jurisdiction of Iowa courts. The Eighth Circuit concluded that the Supreme Court of Iowa would not adopt a seller's contention that personal jurisdiction would exist in this situation. Such an imposition of personal jurisdiction could have a disastrous effect on Iowa's agricultural economy and would violate U.S. due process standards. The court criticized the Iowa-based seller for not insisting that its Chinese buyer obtain an international commercial letter of credit which is "the prevailing way to protect sellers in international export/import transactions." *Hawkeye Gold, LLC v. China National Materials Industry Import and Export Corp.*, 89 F4th 1023 (8th Cir. 2023), cert. denied, 2024 US LEXIS 2461. See § 3.07[1], § 11.02[1][b].

Standing. The fact that a contract is part of a circular trade does not mean that it is ipso facto a sham or fraudulent transaction. There are legitimate commercial reasons for circular trades such as obtaining liquidity of funds in an interim period or making arbitrage profits or brokerage fees. Under Singapore law, a representative office is not the legal equivalent of a branch office. This office and co-plaintiff had previously been a branch. UCP 600 article 3 does not address the issue of standing. How commercial parties relate to each other in relation to a letter of credit transaction conceptually differs from the juridical status of a party to sue in a particular court. This co-plaintiff lacked standing. *Banque De Commerce Et De Placements SA, DIFC Branch and Banque De Commerce Et De Placements SA v. China Aviation Oil (Singapore) Corporation Ltd,* [2024] SGHC 145. See § 6.04[4][c], § 9.03[2].

Fraudulent conduct of a stranger. The Supreme Court of Canada found that an injunction can preclude payment by the issuing bank to a beneficiary when the beneficiary both knew of a third party's fraud and participated in that fraud when it demanded payment. A beneficiary that knows of and acts upon a third party's fraud to demand payment is not innocent of that fraud. The fraud exception applies to such a situation. This decision lends support to the integrity of international commercial arbitration and highlights the need for a party to seek formal recognition of a foreign judgment it intends to rely upon. Without a successful application for recognition and enforcement, a foreign judgment is merely evidence and the weight to be given to such a judgment is an issue of fact to which deference is owed on appeal. In this case, no weight was given to the judgment of a Greek court. *Eurobank*

Ergasias S.A. v. Bombardier Inc., 2024 SCC 11. See § 7.04[5][d], § 9.06[5][f].

Lease cap. Under the Bankruptcy Code, when a letter of credit is given in lieu of a cash security deposit, the credit proceeds reduce the landlord's capped claim. A letter of credit provided by a debtor-tenant should be treated in the same way as a security deposit. The tenant was the credit applicant, but was not the debtor. Instead, the party who provided the funds for the credit and guaranteed the lease obligation was the debtor. Estate assets in the debtor's case were used to reimburse the issuing bank under the debtor's chapter 11 plan. The bankruptcy court correctly held that the credit should be deducted from the landlord's claim after the Bankruptcy Code Section 502(b)(6) calculation was completed. *Lincoln Triangle Commercial Holding Co. LLC v. Halperin (In re Cortlandt Liquidating LLC)*, 658 BR 244 (SDNY 2024). See § 7.03[3][k].

Injunctions. The difficulty of bringing an action in a foreign jurisdiction, without more, does not constitute irreparable harm. The credit applicant assumed the risk of enforcing a money judgment in Taiwan since a transnational enforcement action is a foreseeable consequence of relying on letters of credit in a transaction with an international company. The forum selection clause in the underlying sales contract provided that California courts had personal jurisdiction over the seller-defendant for disputes arising under that contract. The letter of credit is independent of this contract. There was no fraud as the beneficiary had a colorable claim. The parties had a genuine dispute regarding the underlying sales contract. Although Taiwanese courts do not automatically recognize foreign judgments, Taiwan has a process for recognizing foreign judgments. The court denied the applicant's request for a temporary restraining order that would have enjoined the issuing bank from making payments to the Taiwanese beneficiary. *Consolidated Electrical Distributors v. United Renewable Energy Co.*, 2024 US Dist. LEXIS 25290, 113 UCC Rep. Serv. 2d (CBC) 396 (SD Cal. Feb.13, 2024). See § 9.03[4], § 11.05[3][d].

Effect of sanctions. The lower UK court erred when it found that the UK's Russian sanctions regulation did not prevent a confirming bank from paying beneficiaries of credits associated with aircraft leases to a Russian lessee. These leases were executed before the prohibitions were imposed. Nothing in the regulation limited its effect to transactions entered into on or after March 1, 2022. There was no grace period. The regulation's words "in connection with" are broad. This regulation is a blunt instrument that seeks to put pressure on Russia. Since this approach may unintentionally catch arrangements that should not be precluded, the UK government provided exceptions via the licensing regime. There was no support in the regulation's language for the lower court judge to read it as only affecting the future supplies of goods. That opinion was overturned.

Regulation 38(c) prevented the confirming bank's payment under the letters of credit. *Celestial Aviation Services Limited v. Unicredit Bank GMBH, London Branch*, [2024] EWCA Civ 628. See § 9.06[7], § 12.05[5].

The following publications and law review articles may be of interest to readers:

Samuel P. Baycer, Student Article, "Updating Standby Letter of Credit Practice for the 21st Century: Modernizing the International Standby Practices for Digital Transactions," 62 Duq. L. Rev. 407 (2024). This Article focuses on ISP 98 and eUCP and proposes the adoption of a supplement to the ISP98 to reflect changes such as digital trade finance, smart contracts, artificial intelligence, and machine learning. This Article addresses ISP98's deficiencies and argues for changes in letter of credit rules or, alternatively, incorporated in letters of credit, in order to modernize letter of credit transactions.

David Frisch & Nicole Dalrymple, "Oops! The Unfortunate (But Basic) Error in the New UCC Article 12," 11 Tex. A&M L. Rev. 515 (2024), DOI: https://doi.org/10.37419/LR.V11.I3.2. The authors provide an overview of UCC Article 12, which addresses controllable electronic records (CERs). They discuss the concepts of control and the term "qualifying purchaser," how the good faith purchase doctrine is reflected in this new UCC Article and how other UCC Articles have handled the introduction of a thief into the chain of title. In particular, the authors explain the fundamental problem that results from the drafters' use of the term "purchaser." They conclude that in order to prevent legal uncertainty, action must be taken to correct this problem. At p. 536, they state: "It is fair to suggest that the inconsistency of the definition of the term 'purchaser' in Article 12 and the clearly stated goal of the drafters to provide CERs with a heightened form of negotiability that would allow even a thief to pass good title will eventually be cured by an appropriate change to the statute at some future date, much like the wrinkles that were ironed out of Article 3."

Steven L. Schwarcz, "Rethinking Commercial Law's Uncertain Boundaries," 14 Harv. Bus. L. Rev. 234 (2024). This Article hypothesizes and tests possible explanations for why commercial law has uncertain boundaries and analyzes what those boundaries should be. The Article argues that commercial law should cover business-related transfers of property, subject to exceptions necessary to reduce transaction costs and increase economic efficiency.

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