

1984

## The Standby Letter of Credit: What It Is and How To Use It

Jim L. Banks

*University of Montana School of Law*

Follow this and additional works at: <https://scholarworks.umt.edu/mlr>



Part of the [Law Commons](#)

Let us know how access to this document benefits you.

---

### Recommended Citation

Jim L. Banks, *The Standby Letter of Credit: What It Is and How To Use It*, 45 Mont. L. Rev. (1984).

Available at: <https://scholarworks.umt.edu/mlr/vol45/iss1/3>

This Comment is brought to you for free and open access by ScholarWorks at University of Montana. It has been accepted for inclusion in Montana Law Review by an authorized editor of ScholarWorks at University of Montana. For more information, please contact [scholarworks@mso.umt.edu](mailto:scholarworks@mso.umt.edu).

# COMMENTS

## THE STANDBY LETTER OF CREDIT: WHAT IT IS AND HOW TO USE IT

Jim L. Banks

### I. INTRODUCTION

Entering into a commercial or financial transaction always involves certain risks for the seller or the financier. The most serious risk is that of not being paid. There are many methods available to help ensure payment. One such method is through the use of a letter of credit.

The letter of credit substitutes the credit of a third party, usually a bank, for that of the buyer or debtor. In transactions in which a commercial letter of credit is used,<sup>1</sup> the bank agrees to pay the seller for the goods sold, usually upon presentation of a document stating that the goods have been received by the buyer. In transactions in which a standby letter of credit is used, the bank agrees to pay the financier if the debtor defaults upon his obligation to pay. In both cases, the seller or financier is assured of payment, provided the conditions of the letter of credit are satisfied. Upon payment by the bank, the buyer or debtor is obligated to reimburse the bank.

### II. THE LETTER OF CREDIT TRANSACTION

Three legal relationships exist in a letter of credit transaction. First is the contractual relationship between the seller and buyer or the financier and debtor evidenced by a contract for the sale of goods or a contract to lend money. The underlying contract, in addition to creating an obligation of payment or performance, requires the buyer or debtor to arrange for a bank (the issuer)<sup>2</sup> to

---

1. The commercial letter of credit arose to facilitate international commercial transactions involving the sale of goods. More recently, the use of the letter of credit has expanded to include securing the performance of a party in a variety of situations. When a letter of credit is used in this way, it is referred to as a standby letter of credit. See generally H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* (5th ed. 1974). See *infra* text accompanying note 20 for a discussion of the differences between commercial letters of credit and standby letters of credit.

2. Uniform Commercial Code § 5-103(1)(c) (1977) [hereinafter cited as U.C.C.] defines "issuer" as a bank or other person issuing a letter of credit. In this comment, the terms

issue a letter of credit to the seller or financier (the beneficiary).<sup>3</sup> Second is the contractual relationship between the bank and the buyer or debtor (the bank's customer).<sup>4</sup> The customer arranges for the bank to issue the letter of credit in favor of the beneficiary, and the customer agrees to pay the bank for the amounts paid under the letter of credit. Third is the relationship between the issuer and the beneficiary. This relationship is evidenced by the letter of credit.<sup>5</sup> In most cases, Article Five of the Uniform Commercial Code (UCC) governs the use and interpretation of letters of credit.<sup>6</sup> The UCC defines a letter of 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 letter of credit."<sup>7</sup> There is no particular form required for a letter of credit other than that it must be in writing and signed by the issuer.<sup>8</sup> No consideration is necessary.<sup>9</sup>

These three relationships are separate and distinct. The letter of credit is independent from the underlying business transaction between the bank's customer and the beneficiary of the letter of credit.<sup>10</sup> This independence from the underlying contract creates a primary obligation on the part of the bank to the beneficiary and is the key to the utility of a letter of credit.<sup>11</sup> The bank's obligation to honor the letter of credit is not conditioned upon performance or nonperformance of the underlying contract. Instead, the bank's only obligation is to determine whether the drafts or demands for payment made by the beneficiary comply with the conditions specified in the letter of credit.<sup>12</sup>

---

"issuer" and "bank" will be used interchangeably.

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

4. U.C.C. § 5-103(1)(g) (1977) defines "customer" as a buyer or other person who causes an issuer to issue a letter of credit.

5. A letter of credit is not a contract. The beneficiary does not enter into any agreement with the issuer. No consideration is needed. U.C.C. § 5-105 (1977). Nor is a letter of credit a third party beneficiary contract. The claim of the beneficiary is not subject to the same defenses (failure of condition and anticipatory breach) as that of a true third party beneficiary's claim.

6. A body of law dealing mainly with international commercial letters of credit has also developed. This body of law is known as the UNIFORM CUSTOMS AND PRACTICES FOR DOCUMENTARY CREDITS and is promulgated by the International Chamber of Commerce.

7. U.C.C. § 5-103(1) (1977).

8. U.C.C. § 5-104(1) (1977).

9. U.C.C. § 5-105 (1977).

10. U.C.C. § 5-109(1)(a) (1977).

11. See *infra* text accompanying notes 50-67 for a discussion of how a standby letter of credit can be used to avoid loss caused by a debtor's bankruptcy.

12. U.C.C. § 5-114(1) (1977).

If the letter of credit requires presentation of documents for payment,<sup>13</sup> then the bank must examine the documents with care to ascertain whether, on their face, they appear to comply with the terms of the letter of credit.<sup>14</sup> If the conditions specified in the letter of credit have been satisfied, the bank must pay the beneficiary unless a required document is forged or fraudulent, or there is fraud in the transaction.<sup>15</sup> If the fraud or forgery is not apparent on the face of the document, the bank may not refuse payment even if notified by its customer that there has been a fraud or a forgery committed.<sup>16</sup> A court may, however, enjoin payment in such a case.<sup>17</sup>

Upon payment of the letter of credit by the bank, the customer has no cause of action against the bank for improperly honoring the demand for payment unless the bank accepted noncomplying documents and did not use care and good faith in examining them.<sup>18</sup> When the beneficiary makes a demand for payment of the letter of credit, he warrants to all interested parties that the necessary conditions of the letter of credit have been satisfied.<sup>19</sup> If the beneficiary has made an improper demand for payment and did in fact receive payment, then the customer has a cause of action against the beneficiary for breach of this warranty.

### III. TYPES OF LETTERS OF CREDIT

#### A. "Commercial" or "Standby"

Letters of credit are classified as either commercial or standby letters of credit. Classification depends upon the context of the business transaction in which they are utilized and the function that they serve. The traditional commercial letter of credit is used in transactions involving the sale of goods, whereas the standby

---

13. See *infra* text accompanying notes 23-27 for a discussion of the differences between "documentary" and "clean" letters of credit and a definition of "document."

14. U.C.C. § 5-109(2) (1977).

15. U.C.C. § 5-114(2) (1977). Fraud in the transaction must stem from conduct by the beneficiary as against the customer of the bank. The fraud must be of such an egregious nature as to invalidate the underlying transaction. *Colorado Nat'l Bank v. Board of County Comm'rs*, \_\_\_ Colo. \_\_\_, 634 P.2d 32, 39 (1981).

16. U.C.C. § 5-114(2)(b) (1977).

17. *Id.* (California deleted this part of § 5-114(2)(b) when it adopted the U.C.C. 1963 Cal. Stat. 819 (codified at CAL. COM. CODE §§ 1101-11109 (West 1964)) (effective Jan. 1, 1965)).

18. U.C.C. § 5-109(1)-(2) (1977).

19. U.C.C. § 5-111(1) (1977).

letter of credit<sup>20</sup> is used to secure the performance of contracts or other obligations.<sup>21</sup> The UCC does not differentiate between the two types of letters of credit; Article Five applies regardless of the nature of the underlying transaction.

Although the two types of letters of credit may be identical in format and treated alike by the UCC, the expectations of the parties involved are exactly opposite in the two types of letters of credit. The traditional commercial letter of credit is used as a payment service and is expected to be drawn upon, whereas the standby letter of credit acts as a means of securing payment if the bank's customer defaults on the underlying obligation. In other words, with a commercial letter of credit, if the underlying transaction goes through, payment is made on the letter of credit. In contrast, with a standby letter of credit, if the underlying transaction does *not* go through, payment is made on the letter of credit.<sup>22</sup>

### B. "Documentary" or "Clean"

Both commercial and standby letters of credit can be either documentary or clean credits. "Documentary" refers to the requirement of presentation of a document for payment. If the letter of credit is issued by a bank, the document can be any piece of paper, including a document of title, an invoice, a certificate, a notice of default, or the like.<sup>23</sup> Comment 1 to UCC section 5-102 states that, as far as banks are concerned, the document can range from a notice that goods have been sent to a notice of default of some kind. If the issuer is not a bank and the letter of credit requires that the demand for payment be accompanied by a document, then that document must be a document of title.<sup>24</sup>

A letter of credit, however, need not require presentation of a document for payment. The UCC provides that a bank or non-bank issuer may issue a letter of credit which does not require

20. Standby letters of credit are also referred to as "guaranty" letters of credit. To avoid confusion with a contract of guaranty or suretyship, this comment will use the term "standby letter of credit."

21. The Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation define a standby letter of credit as follows:

Any letter of credit which represents an obligation to the beneficiary on the part of the issuer: (1) to repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation.

12 C.F.R. §§ 208.8(d), 32.2(e), 337.2(a) (1983).

22. A.L.I.-A.B.A., Course of Study Materials, *Letters of Credit*, 1981, at 5.

23. U.C.C. §§ 5-102(1)(a), 5-103(1)(b) (1977).

24. U.C.C. § 5-102(1)(b) (1977).

presentation of a document if the letter of credit "conspicuously states that it is a letter of credit or is conspicuously so entitled."<sup>25</sup> This type of letter of credit is known as a "clean" letter of credit<sup>26</sup> and requires only a draft or demand for payment and no other document.<sup>27</sup>

#### IV. STANDBY LETTER OF CREDIT V. GUARANTY

Standby letters of credit are typically presented to a bank for payment because the customer has defaulted on his underlying obligation due to financial difficulties. Knowing that they may have difficulty collecting from their customer if they honor the standby letter of credit, some banks have looked for ways to avoid paying the beneficiary. Because national banks lack the authority to act as guarantors for the performance of contracts made by others,<sup>28</sup> issuing banks have argued that an instrument was a guaranty rather than a standby letter of credit, so that its issuance was an unenforceable *ultra vires* act.<sup>29</sup>

Although a standby letter of credit appears to function as a guaranty in many ways, there are several important distinctions between the two. A guaranty is a promise to answer for the debt or default of another person.<sup>30</sup> This creates a secondary obligation on the part of the guarantor that is dependent upon the nonperformance of the underlying contract. The guarantor can only be called upon to perform once the primary obligor has, in fact, defaulted or breached. The obligations of the guarantor can only be defined by a factual determination of the rights and obligations of the parties to the underlying contract. Furthermore, the guarantor can use any and all defenses that the primary obligor has against the creditor.

In contrast, with a standby letter of credit, the bank's liability does not rest upon the underlying contract between the bank's cus-

25. U.C.C. § 5-102(1)(c) (1977).

26. See U.C.C. § 5-102 comment 1 (1977).

27. A clean letter of credit (as opposed to a documentary letter of credit) does not give the customer as much protection against improper demand because of the lack of documentary compliance provisions.

28. *Texas & Pac. Ry. v. Pottorf*, 291 U.S. 245, 253 (1934). The Court held that the powers of national banks are limited to those powers specifically granted to them by statute; and powers not conferred by Congress are denied. Therefore, because Congress had not specifically conferred upon national banks the power to act as guarantors, they were prohibited from doing so. See also Harfield, *The National Bank Act and Foreign Trade Practice*, 61 HARV. L. REV. 782, 788 (1948).

29. See, e.g., *New Jersey Bank v. Palladine*, 77 N.J. 33, 389 A.2d 454 (1978); *Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109 (Tex. 1978).

30. MONT. CODE ANN. § 28-11-101 (1983).

tomor and the beneficiary of the letter of credit.<sup>31</sup> The letter of credit creates a primary obligation between the issuer and the beneficiary,<sup>32</sup> and that obligation is independent of the underlying contract. The issuer must honor a demand for payment which complies with the relevant terms of the letter of credit. Performance of the underlying contract is irrelevant to the bank's obligation under the letter of credit.<sup>33</sup>

It is well established today that the standby letter of credit is not a guaranty.<sup>34</sup> All three federal government agencies that regulate banks have recognized that banks have the authority to issue standby letters of credit.<sup>35</sup> Care must be taken, however, in drafting the instrument to ensure that it is treated as a standby letter of credit rather than as a guaranty. An instrument is a standby letter of credit if "the issuer has a primary obligation that is dependent solely upon presentation of conforming documents [or demands for payment] and not upon the factual performance or non-performance by the parties to the underlying transaction."<sup>36</sup>

By contrast, if the conditions of compliance are phrased in factual rather than in documentary terms, the honoring of the instrument becomes contingent upon the actual occurrence or nonoccurrence of a factual event. Under such conditions, the issuer, rather than examining documents which state that an event has or has not occurred, would be required to examine questions of fact relating to the performance of the underlying contract. These are the characteristics of a guaranty, not of a standby letter of credit.

The problems created by the use of factual conditions for payment instead of presentation of documents are illustrated in *Wichita Eagle & Beacon Publishing Co. v. Pacific National Bank*.<sup>37</sup> Pacific Bank issued an instrument to Wichita Eagle to secure payment on a lease and a construction contract. The instrument,

31. *Colorado Nat'l Bank v. Board of County Comm'rs*, \_\_\_ Colo. \_\_\_, 634 P.2d 32, 37 (1981).

32. *Boise Cascade v. First Security Bank of Anaconda*, 183 Mont. 378, 388, 600 P.2d 173, 179 (1979).

33. U.C.C. § 5-109(1)(a) (1977).

34. See, e.g., cases cited *supra* note 29.

35. With respect to national banks, the Comptroller of the Currency has promulgated 12 C.F.R. § 32.2(e) (1983). With respect to state banks that are members of the Federal Reserve System, the Board of Governors of the Federal Reserve System has promulgated 21 C.F.R. § 208.8 (1983). With respect to state banks that are not members of the Federal Reserve System but are insured through the Federal Deposit Insurance Corp. (F.D.I.C.), the F.D.I.C. has promulgated 12 C.F.R. § 337.2 (1983).

36. *Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109, 115 (Tex. 1979).

37. 343 F. Supp. 332 (N.D. Cal. 1971), *rev'd*, 493 F.2d 1285 (9th Cir. 1974).

which was entitled "Letter of Credit,"<sup>38</sup> stated that payment would be made upon presentation of a sight draft, provided that all of the stated conditions existed at the time the draft was received by the issuer.<sup>39</sup> The customer defaulted on the construction contract, and Wichita Eagle presented a sight draft and statements asserting that the conditions had been met. Pacific Bank refused to pay, contending that the obligation was not a standby letter of credit, but rather a guaranty, and therefore its issuance was an ultra vires act and the instrument was unenforceable. The trial court did not accept Pacific Bank's guaranty theory and held that the instrument was a valid standby letter of credit.<sup>40</sup>

The Ninth Circuit reversed the trial court and held that the instrument was a guaranty.<sup>41</sup> The court reasoned that, because of the terms of the instrument, the bank could only determine if the conditions for payment had been met by making a determination as to the actual existence of facts regarding the performance of the underlying construction contract.<sup>42</sup> The court found that, because of this requirement, the instrument had strayed "too far from the basic purpose of letters of credit, namely, providing a means of assuring payment cheaply by eliminating the need for the issuer to police the underlying contract."<sup>43</sup>

The instrument in *Wichita Eagle* was issued in California in 1962, before California had adopted the UCC.<sup>44</sup> An argument could be made that, under a literal interpretation of section 5-102(1)(c) of the UCC, the holding in *Wichita Eagle*, had it been decided under the UCC, should have been different. Section 5-102(1)(c) provides that a letter of credit need not require presentation of a document provided that the letter of credit conspicuously states that it is a letter of credit or is conspicuously so entitled. This is a

---

38. *Wichita Eagle*, 343 F. Supp. at 341-42.

39. Note that requiring the conditions to exist is different from requiring a document (such as an affidavit) from the beneficiary stating that the conditions exist. In the first instance, the burden of determining facts relating to the underlying contract is placed upon the bank. In the second instance, the bank's only burden is to examine the document to see if, on its face, the document appears to comply with the terms of the letter of credit.

40. *Wichita Eagle*, 343 F. Supp. at 338-39.

41. *Wichita Eagle & Beacon Publishing Co. v. Pac. Nat'l Bank*, 493 F.2d 1285 (9th Cir. 1974). Although the court found the instrument to be a guaranty, it upheld the validity of the guaranty and increased the damage award by \$87,000. The court did not explain why it allowed a guaranty to be enforced against a national bank. See *supra* notes 28 & 29 and accompanying text.

42. *Wichita Eagle*, 493 F.2d at 1286.

43. *Id.*

44. California adopted the U.C.C. in 1963 with an effective date of Jan. 1, 1965. CAL. COM. CODE § 10101 (West 1964).

"clean" letter of credit.<sup>45</sup> A literal interpretation of this section would have found the instrument in *Wichita Eagle* to be a letter of credit since it was entitled "Letter of Credit." Both section 1-102 and comment 1 to section 5-102 call for a liberal interpretation to promote expanded commercial practices through agreement of the parties. The court in *Wichita Eagle*, not bound by the UCC, considered the fact that the instrument was entitled "Letter of Credit" but found that the intent of the parties "is manifested by the terms of the agreement, not by its label."<sup>46</sup> The court held that, because of the way in which the instrument was phrased, the bank was required to determine the existence of the conditions mentioned in the instrument.

Other courts have resolved the problem that arose in *Wichita Eagle* by adopting the following presumption: If the issuer fails to provide for documentation of a particular fact, then there is a presumption that, when the beneficiary makes demand for payment, the factual conditions have been satisfied. In *Bank of America v. Whitney-Central National Bank*,<sup>47</sup> the court stated:

A bank may issue its letter of credit unconditionally, and without requiring documents, or it may prescribe such conditions and require such documents as it sees fit. [citation omitted] It follows that when any particular fact is not required to be represented by documents the letter of credit is unconditional as to such fact, and in that event the issuing bank is presumed to rely upon the representation of the person in whose favor the credit is issued.<sup>48</sup>

Contrary to *Wichita Eagle*, the reasoning of *Bank of America* gives effect to the intent of the parties. When an agreement calls for the issuance of a letter of credit and the beneficiary receives an instrument from the bank entitled "Letter of Credit," he should be entitled to rely upon such a representation. Courts should protect the beneficiary who enters into an agreement with the expectation that the bank will honor its commitment, not renege on it. These problems can be avoided by a careful drafting of the letter of credit.<sup>49</sup>

## V. LETTERS OF CREDIT AND BANKRUPTCY

In 1979, a bankruptcy court in Florida sent a temporary chill

---

45. See *supra* text accompanying notes 25-27.

46. *Wichita Eagle*, 493 F.2d at 1286.

47. 291 F. 929 (5th Cir. 1923).

48. *Id.* at 935.

49. See *infra* text accompanying notes 70-77.

through the world of commercial finance. In *In re Twist Cap*,<sup>50</sup> the court enjoined a bank from honoring two standby letters of credit. The court held that, because the customer of the bank had filed a bankruptcy petition, the beneficiary of the letters of credit could not receive payment because the payment would constitute an impermissible preference.<sup>51</sup> The holding was not appealed because the debtor subsequently consented to the honoring of the letters of credit.<sup>52</sup> This aberration of the law pertaining to letters of credit caused immediate concern among attorneys who work with letters of credit.<sup>53</sup>

Courts in subsequent cases have not followed *Twist Cap*. In *In re MJ Sales & Distributing Co.*,<sup>54</sup> the bankruptcy trustee requested the court to enjoin payment on a standby letter of credit that the debtor had caused to be issued. The trustee was proceeding under the theory that payment of the letter of credit would be an impermissible preference which was voidable under section 547 of the Bankruptcy Code.<sup>55</sup> The court refused to enjoin payment, holding that "a bank honors a letter of credit and pays the beneficiary with its own funds, and not with assets belonging to the [customer]. . . . [N]o preference occurs when the payment depletes the assets of the [issuer] and not those of the [customer]."<sup>56</sup>

Similarly, in *Westinghouse Credit Corp. v. Page*,<sup>57</sup> the district court reversed a bankruptcy court's order enjoining payment on a standby letter of credit. The bankrupt debtor had defaulted on an underlying loan that was secured by a standby letter of credit. When the beneficiary of the letter of credit made demand for payment, the bankruptcy court enjoined payment. The bankruptcy court held that the bank's payment of the letter of credit would constitute a transfer of assets in violation of sections 362 and 549 of the Bankruptcy Code.<sup>58</sup>

---

50. 1 Bankr. 284 (Bankr. D. Fla. 1979).

51. *Id.* at 285.

52. Chaitman & Sovern, *Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest In a Twist Cap*, 38 BUS. LAW. 21, 31 (1982) [hereinafter cited as Chaitman & Sovern].

53. The decision disrupted the practice of issuing commercial paper backed by a standby letter of credit. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130, 132 (1982).

54. 25 Bankr. 608 (Bankr. S.D.N.Y. 1982).

55. 11 U.S.C. § 547 (Supp. IV 1980). The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978), became effective October 1, 1979. Bankruptcy statutes prior to the current provisions were commonly referred to as the "Act." The current statutes are commonly called the "Bankruptcy Code" or the "Code."

56. *MJ Sales*, 25 Bankr. at 614.

57. 18 Bankr. 713 (D.D.C. 1982).

58. 11 U.S.C. §§ 362, 549 (Supp. IV 1980).

Section 362—the automatic stay provision—provides that the filing of a bankruptcy petition operates as a stay of “any act to obtain possession of property of the [bankruptcy] estate or of property from the estate; and any act to create, perfect, or enforce any lien against property of the estate.”<sup>59</sup> The district court in *Westinghouse Credit* concluded that, because neither the letter of credit nor the proceeds upon payment are property of the bankruptcy estate, the bankruptcy stay should not prevent the bank from honoring the letter of credit. The court reasoned that, in issuing the letter of credit, the bank entered into an independent obligation with the beneficiary. When a bank honors a letter of credit, the payment is made with the bank’s money, not with property from the bankruptcy estate. The court held that honoring the letter of credit would not create, perfect, or enforce a lien against the property of the bankruptcy estate.<sup>60</sup> Of course, the bank will have a claim against the debtor for the amount of the letter of credit, but any attempt to enforce the claim would be stayed under section 362.

Generally, section 549 of the Bankruptcy Code bars a postpetition transfer of property belonging to the bankruptcy estate.<sup>61</sup> The district court found that, for essentially the same reasons that honoring a letter of credit does not violate the automatic stay provision, honoring a letter of credit does not violate section 549. That is, the letter of credit and its proceeds represent property of the bank, not of the bankruptcy estate.<sup>62</sup>

Another theory alleged in the *Twist Cap* complaint but not addressed by the bankruptcy court<sup>63</sup> was that letters of credit are executory contracts and subject to rejection by the bankruptcy trustee.<sup>64</sup> An executory contract in the bankruptcy context is defined as “a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”<sup>65</sup> This theory has no merit for two reasons. First, a letter of credit is not a

---

59. 11 U.S.C. § 362(a)(3)-(4) (Supp. IV 1980).

60. In the case in which the bank has a security interest in property of the debtor as collateral on the letter of credit, the lien is considered to have been created and perfected at the time the agreement was entered into. *Westinghouse Credit*, 18 Bankr. at 716.

61. 11 U.S.C. § 549(a)(1) (Supp. IV 1980).

62. *Westinghouse Credit*, 18 Bankr. at 716.

63. See Chaitman & Sovern, *supra* note 52, at 21.

64. 11 U.S.C. § 365(a) (Supp. IV 1980) provides that the trustee, subject to the court’s approval, may assume or reject any executory contract of the debtor.

65. Countryman, *Executory Contracts in Bankruptcy, Part I*, 57 MINN. L. REV. 439, 460 (1973).

contract.<sup>66</sup> Second, the debtor is not a party to the letter of credit. A letter of credit represents a relationship between the issuer and the beneficiary; the bankrupt debtor has no obligations under the letter of credit.

The court in *Westinghouse Credit* stressed that enjoining the payment of a letter of credit, even temporarily, would frustrate the commercial purpose of the letter of credit. "If payment . . . could be routinely delayed by filing a [bankruptcy] petition the intended substitution of a bank for its less credit-worthy customer would be defeated. As a consequence the letter of credit would become a dubious device for securing credit."<sup>67</sup>

Decisions such as *MJ Sales* and *Westinghouse Credit*, together with the complete absence of any cases following the *Twist Cap* rationale, have restored the confidence of those who deal with standby letters of credit. It is again safe to rely upon the assumption that courts will recognize that the payment of a letter of credit by a bank does not violate any of the Bankruptcy Code's provisions designed to protect the bankruptcy estate. The standby letter of credit can be depended upon to secure credit; and it is particularly well suited for protecting a creditor from losses caused by a debtor's bankruptcy.

## VI. BUSINESS USES OF THE STANDBY LETTER OF CREDIT

The great utility of the standby letter of credit is reflected in the fact that it can be used in practically any situation in which one party to a contract is concerned with the other party's ability to perform. Some of the many ways in which a standby letter of credit can be used are: to ensure payment or performance in construction financing, corporate consolidations, real estate transactions, management contracts, leases on real and personal property, stock transfers and purchases, and bid and performance bonds; to ensure payment of salaries to highly paid individuals such as professional athletes and entertainers; and to ensure payment of professional services such as attorney's fees.

Standby letters of credit can also be used to guarantee payment in cases where a taxpayer has sold property and is using the "installment method"<sup>68</sup> of reporting the income from the sale. A

---

66. See *supra* note 5.

67. *Westinghouse Credit*, 18 Bankr. at 717.

68. An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. I.R.C. § 453(b)(1) (CCH 1983). The term "installment method" means a method under which the income recognized for any taxable year from a disposition of property is that proportion of the pay-

cash method taxpayer can probably, by using a standby letter of credit to guarantee payment, defer income to the future and at the same time be assured of receiving the income at the specified future date.<sup>69</sup>

## VII. DRAFTING A STANDBY LETTER OF CREDIT

Careful drafting of a standby letter of credit is necessary to prevent the possibility of it being treated as a guaranty. The letter of credit should conspicuously state that it is a letter of credit or be entitled "Letter of Credit."<sup>70</sup> Although a letter of credit may be either revocable or irrevocable,<sup>71</sup> an irrevocable letter of credit gives the beneficiary more protection. The letter of credit should include an expiration date for presentation for payment<sup>72</sup> and should state a maximum amount payable.<sup>73</sup>

Although the UCC specifically provides for clean letters of credit<sup>74</sup> in which the beneficiary need only make a demand for payment without any accompanying document,<sup>75</sup> this type of payment-triggering mechanism in the standby context gives the customer very little protection against wrongful demand for payment. The letter of credit should state that the issuer's obligation to pay arises only upon a demand for payment accompanied by the document specified in the letter of credit. Care must be taken so that the letter of credit does not require the issuer to make factual de-

---

ments received in that year which the gross profit bears to the total contract price. I.R.C. § 453(c) (CCH 1983). See also Treas. Reg. § 15a.453-1(b)(5) (CCH 1983) (example 7 uses a standby letter of credit to secure an installment obligation).

69. A caveat must be added to this suggested use of the standby letter of credit. The tax doctrines of constructive receipt and economic benefit or cash equivalency could present problems for this use of the standby letter of credit. A detailed analysis of the application of these two doctrines to the use of a standby letter of credit for income deferral is beyond the scope of this comment. See Rev. Rul. 71-419, 1971-2 C.B. 220; Rev. Rul. 60-31, 1960-1 C.B. 174; Chapman v. United States, 527 F. Supp. 1053 (D. Minn. 1981); Goldsmith v. United States, 586 F.2d 810 (Ct. Cl. 1978); Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

70. U.C.C. § 5-102(1)(c) (1977).

71. U.C.C. § 5-103(1)(a) (1977).

72. The expiration date should be specified in the letter of credit. The expiration date should not refer to the underlying contract or some event tied to it such as 30 days after default of the underlying debt. Making the expiration date dependent upon an event related to the underlying contract could require the bank to make a determination of fact.

73. National banks may not issue standby letters of credit for any one customer in an amount in excess of 10% of the bank's unimpaired capital and unimpaired surplus. 12 C.F.R. § 32.4 (1983). Banks organized under Montana law are restricted to issue letters of credit for any one customer in amounts not exceeding 20% of the capital and surplus of the bank. MONT. CODE ANN. § 32-1-437 (1983).

74. See U.C.C. § 5-102 comment 1 (1977).

75. See *supra* text accompanying note 27.

terminations. The issuer's only duty should be to determine whether the document, on its face, appears to comply with the terms of the letter of credit.<sup>76</sup> This document can be anything that the parties agree to, such as a certificate or affidavit from the beneficiary acknowledging a default by the customer, a third party certificate of nonperformance, the sworn statement of an independent consultant, or a sworn statement that a demand for payment has been made upon the customer and such payment has not been made.<sup>77</sup> Requiring such a document protects the customer because false statements or affidavits could provide a basis for civil and criminal actions for fraud or misrepresentation. A sample documentary standby letter of credit and the demand for payment and accompanying document are included in the appendix to this comment.

### VIII. SUMMARY

The standby letter of credit is neither a contract nor a negotiable instrument,<sup>78</sup> and if it is properly drafted, it will not be considered a guaranty. The standby letter of credit is a distinct legal instrument, unlike any other. The obligation of the issuer of the letter of credit is independent of the underlying contract between the issuer's customer and the beneficiary of the letter of credit.

The standby letter of credit enables a businessman to enter into business ventures with minimal fear of loss. By substituting the credit of a third party, usually a bank, for that of the debtor, the businessman can help to protect his investment. Finally, the standby letter of credit is particularly well suited for preventing loss or delay of payment caused by the debtor's bankruptcy. Because the standby letter of credit and its proceeds are not part of the bankruptcy estate, the beneficiary of a standby letter of credit should receive payment from the bank without delay. The low cost<sup>79</sup> and adaptability to a wide range of business transactions make the standby letter of credit very attractive to the business community and to business lawyers.

---

76. See *supra* text accompanying notes 36-39.

77. See U.C.C. § 5-102 comment 1 (1977).

78. A letter of credit does not meet the requirements of negotiability as set forth in U.C.C. § 3-104(1) (1977).

79. Banks generally charge a fee of 1% to 2% per annum of the face amount of the credit to issue a standby letter of credit.

## APPENDIX I

### Standby Letter of Credit

National Bank of Your City  
Your City, Montana

May 1, 1984

#### IRREVOCABLE STANDBY LETTER OF CREDIT No. 191

This Credit Expires December 1, 1986.

Issued to:

ABJ Land Corporation  
111 Development St.  
Your City, Montana

Gentlemen:

We hereby issue in your favor our Irrevocable Standby Letter of Credit in an amount not to exceed \$200,000.00. The purpose of this Standby Letter of Credit is to secure a Promissory Note executed May 1, 1984, by XYZ Builders, Inc., payable to ABJ Land Corporation.

Funds under this Standby Letter of Credit are available upon receipt of a demand for payment accompanied by the following documents:

1. The original Promissory Note executed May 1, 1984, by XYZ Builders, Inc., payable to ABJ Land Corporation.
2. A Certificate, executed by an officer of the ABJ Land Corporation, stating that payment of the Promissory Note is more than 30 days past due, that a demand for payment has been made, and that XYZ Builders, Inc., has failed to pay the Note.

We hereby agree that this Irrevocable Standby Letter of Credit shall be duly honored upon presentation and delivery of the documents as specified above, if presented on or before December 1, 1986.

Cordially yours,

/s/ John Doe

Senior Vice President

National Bank of Your City

**APPENDIX II**  
**Demand Letter**

November 1, 1986

National Bank of Your City  
333 Pine St.  
Your City, Montana

**RE: Irrevocable Standby Letter of Credit No. 191, dated May 1, 1984.**

**Gentlemen:**

On May 1, 1984, you issued Irrevocable Standby Letter of Credit No. 191 on behalf of XYZ Builders, Inc., to ABJ Land Corporation of Your City, Montana. ABJ Land Corporation is hereby drawing on said Letter of Credit and demanding that you pay ABJ Land Corporation forthwith the amount of \$200,000.00.

Enclosed is the said Letter of Credit, the original Promissory Note executed on May 1, 1984, by XYZ Builders, Inc., payable to ABJ Land Corporation, and a Certificate executed by Ronald Roe, President of ABJ Land Corporation, stating that payment of the Promissory Note is more than 30 days past due, that a demand for payment has been made, and that XYZ Builders, Inc., has failed to pay the Note.

ABJ Land Corporation  
By: /s/ Ronald Roe  
President

**APPENDIX III****Certificate**

November 1, 1986

Ronald Roe certifies: that he is the President of ABJ Land Corporation; that payment of the Promissory Note executed May 1, 1984, by XYZ Builders, Inc., payable to ABJ Land Corporation is more than 30 days past due; that a demand for payment has been made; and that XYZ Builders, Inc., has failed to pay the Note.

Signed this 1st day of November, 1986

/s/ Ronald Roe

Subscribed and sworn to before me this  
1st day of November, 1986.

/s/ Henry Stammer

Notary Public

My Commission Expires:

May 1, 1988