Fordham International Law Journal

Volume 4, *Issue* 1 1980 *Article* 7

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Abstract

Courts have been struggling to determine the proper grounds for the issuance of an ”injunction against honor. The purpose of this Note is to analyze exactly which circumstances warrant an injunction against honor. Part I will discuss the origin and development of the relevant law in this area. Part II will analyze those situations in which courts have had to consider issuing injunctions due to active fraud in the underlying transaction. Part III will explore the issue of prospective fraud as a ground for enjoining honor which was raised in the recent Iranian letter of credit litigation.

LETTERS OF CREDIT: EXPLORING THE BOUNDARIES OF INJUNCTIONS AGAINST HONOR

INTRODUCTION

Letters of credit have consistently played an important role in the financing of trade from as far back as the time of the Phoenicians, Babylonians, Assyrians and Greeks.[1] While letters of credit

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1. Wiley, *How to Use Letters of Credit in Financing the Sale of Goods*, 20 BUS. LAW. 495, 495 (1965). In general, there are two types of letters of credit: the commercial letter of credit and the standby letter of credit. In all letter of credit situations there are three parties: the customer who requests that a letter of credit be issued; the issuer, most likely a bank, who issues the letter upon the customer's request; and the beneficiary, who is the party entitled to demand payment under the letter of credit. Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 581-85, 609 (1979).

The operation of a commercial letter of credit is best illustrated by an example. A New York merchant, *M*, decides that he needs one thousand mink coats for his winter line. *M* contacts a Canadian seller, *S*, offering to buy a thousand mink coats. *M* does not mention payment in his offer. Since *S* has not dealt with *M* before and therefore knows nothing about *M*'s honesty or solvency, *S* does not wish to sell on an open account. *S* suggests that *M* pay in advance. *M*, of course, does not wish to pay for goods not yet delivered. Subsequently a letter of credit sale is agreed to by the parties.

M requests his bank (which is large and reputable) to issue a commercial letter of credit naming *S* as the beneficiary. The bank then promises to pay *S* the contract price upon receiving specified documents. Such documents might include a bill of lading, or a signed statement from a neutral party that the goods have arrived in a particular location and are in order. The bank will then look to *M* for reimbursement as well as a finance charge payment pursuant to a security contract between *M* and the bank. If the bank's payment to the beneficiary has been proper (*i.e.*, if the bank has received proper documentation) *M*'s duty to reimburse the bank is absolute. J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE COMMERCIAL CODE § 18-9 (2d ed. 1980).

The standby letter of credit, on the other hand, differs from the commercial letter of credit in that the issuer will pay the beneficiary a certain amount upon documentation stating that its customer has defaulted on the underlying contract. A developer, for example, contracts with a construction company to build an office building. The construction company demands assurance that it will be paid in full upon completion of the building and insists that the developer obtain a standby letter of credit which will make payment available in the event the developer defaults. The developer may also insist that the construction company secure a standby letter of credit in its favor which would provide for liquidated damages in the event that the construction company defaults in its performance.

have financed a vast majority of recent United States merchandise imports,[2] these instruments have become the subject of controversy in the courts during the past forty years.[3] In this controversy the courts have been struggling to determine the proper grounds for the issuance of an "injunction against honor."[4] Indeed, recent banking litigation,[5] fomented by the current international difficulties caused by the Iranian revolution, has focused attention on this subject.[6] Unfortunately, the lack of a well-defined legal doctrine concerning injunctions against honor has resulted in judicial confusion.[7]

The purpose of this Note is to analyze exactly which circumstances warrant an injunction against honor. Part I will discuss the origin and development of the relevant law in this area. Part II will analyze those situations in which courts have had to consider issuing injunctions due to active fraud in the underlying transaction. Part III will explore the issue of prospective fraud as a ground for enjoining honor which was raised in the recent Iranian letter of credit litigation.[8]

Since parties do not expect to be in default, it is not intended that payment will be made under a standby letter of credit. In a commercial letter of credit situation, however, it is fully expected that payment will be made under the letter. This is the major difference between the two. *See* Comment, *Letters of Credit: Current Theories and Usages*, 39 LA. L. REV. 581, 581-85, 609-13 (1979). For a complete analysis of the operation of a letter of credit, see Kozolchyk, *Legal Aspects of Letters of Credit and Related Secured Transactions*, 11 LAW. AM. 265 (1979).

2. 2 W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 791 (1964); Annot., 35 A.L.R.3d 1404, 1407 (1971).

3. *See, e.g.*, Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461 (2d Cir. 1970); Watkins-Johnson Co. v. Wells Fargo Bank, N.A., No. C79-0121 (N.D. Cal. Feb. 27, 1979); Sztejn v. Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

4. *See, e.g.*, Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461 (2d Cir. 1970); Watkins-Johnson Co. v. Wells Fargo Bank, N.A., No. C79-0121 (N.D. Cal. Feb. 27, 1979); Sztejn v. Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). An injunction against honor is an injunction prohibiting the issuer from making payment under a letter of credit. *See* U.C.C. § 5-114.

5. *See, e.g.*, Werner Lehara Int'l, Inc. v. Harris Trust & Sav. Bank, 484 F. Supp. 65 (W.D. Mich. 1980); Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411 (S.D.N.Y. Mar. 30, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979).

6. Rendell, *The Iranian Revolution Continues in the Courts*, EUROMONEY, June 1979, at 73-75; Comment, *Enjoining the International Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L L.J. 189 (1980).

7. *Compare* United Bank Ltd. v. Cambridge Sporting Goods Corp. *with* Dynamics Corp. of America v. Citizens & S. Nat'l Bank. *See* notes 33-44 *infra* and accompanying text.

8. *See, e.g.*, Werner Lehara Int'l, Inc. v. Harris Trust & Sav. Bank, 484 F.

I. THE ORIGIN AND DEVELOPMENT OF THE LAW GOVERNING INJUNCTIONS AGAINST HONOR

A. *The Independent Contracts Rule*

Historically it has been a cardinal principle of commercial law that a bank issuing a letter of credit need not concern itself with the underlying transaction between its customer and the beneficiary.[9] The issuing bank concerns itself only with whether the beneficiary has provided it with the documents required under the letter and not whether the beneficiary has properly performed its contractual duties in the underlying transaction.[10] This rule, referred to as the independent contracts rule,[11] provides for payment of the letter of credit upon objective documentation criteria, without which the parties might not transact business at all.[12]

The independent contracts rule, however, can produce an inequitable result when the transaction is tainted by the beneficiary's fraud.[13] As a result, an exception to the rule of independent contracts was carved out in the landmark case of *Sztejn v. J. Henry Schroder Banking Corp.*[14]

In *Sztejn*, the seller-beneficiary intentionally failed to ship the goods ordered by the buyer-customer. The seller-beneficiary shipped "worthless rubbish," obtained the documentation required under the letter of credit nonetheless, and subsequently demanded that the issuer make payment.[15] The buyer-customer sought an injunction prohibiting the bank from making payment under the letter

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Supp. 65 (W.D. Mich. 1980); Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411 (S.D.N.Y. Mar. 30, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979).

9. *See* Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464-65 (2d Cir. 1970); H. HARFIELD, BANK CREDITS AND ACCEPTANCES 31-32 (5th ed. 1974).

10. *See* Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464-65 (2d Cir. 1970); H. HARFIELD, BANK CREDITS AND ACCEPTANCES 31-32 (5th ed. 1974).

11. H. HARFIELD, *supra* note 9, at 31-32.

12. *See* note 1 *supra*.

13. *See, e.g.*, Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 720-23, 31 N.Y.S.2d 631, 632-35 (Sup. Ct. 1941).

14. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941). Although this case was not decided by New York State's highest court, it is followed by courts throughout this country as well as abroad. *See, e.g.*, Intraworld Indus., Inc. v. Girard Trust Bank, 461 Pa. 343, 359, 336 A.2d 316, 325 (1975). Edward Owen Eng'r, Ltd. v. Barclays Bank, [1977] 1 W.L.R. 764, 764. The latter case was decided by the Court of Appeal of England and Wales. *See also* Kozolchyk, *supra* note 1, at 281.

15. 177 Misc. at 720-21, 31 N.Y.S.2d at 633.

(an injunction against honor).[16] The court granted the injunction and stated that where there has been active and intentional fraud in the performance of the beneficiary's duty to the customer, a court may make an exception to the independent contracts rule and enjoin the issuer from making payment despite proper documentation.[17] The *Sztejn* court held that breach of warranty concerning the quality of the merchandise was not sufficient cause to enjoin honor but rather it must be shown that the unscrupulous beneficiary actively and intentionally defrauded the buyer.[18]

B. *Applicable Law*

Analysis of the law governing the issuance of an injunction against honor focuses almost exclusively on case law rather than statutory law. This is true despite the fact that section 5-114 of the Uniform Commercial Code states the grounds for injunctions against honor.[19] The broad wording of this section—that a court

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16. *See* note 4 *supra*.
17. 177 Misc. at 720-23, 31 N.Y.S.2d at 632-35.
18. *See id.*
19. U.C.C. § 5-114 (1978 version). This section provides:

Issuer's Duty and Privilege to Honor; Right to Reimbursement

(1) An 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 of such a draft or demand 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.

(2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction

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

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

(3) Unless otherwise agreed an issuer which has duly honored a draft or

may enjoin honor when there is "fraud in the transaction"[20]—makes it necessary for a court to review prior case law to determine the types of situations in which honor should be enjoined.[21] New York, the situs of the majority of the letter of credit trade and litigation,[22] added a subsection to section 5-102 of the U.C.C. which states that the U.C.C. shall not apply to a letter of credit if by the terms of the letter, usage of the trade, or course of dealing, the letter is subject, in whole or in part, to the Uniform Customs and Practice Act (U.C.P.).[23] Since it is customary for letters of credit to state that they are subject to the U.C.P.,[24] this further reduces the instances in which the U.C.C. may be relied upon as authority. The U.C.P., however, is simply a recording of the practices and procedures followed in the commercial world and not a compilation of legal rules,[25] and as such does not govern the issuance of an injunction.[26] Thus, case law rather than statutory law governs the issuance of injunctions against honor.

An injunction is an extraordinary, equitable remedy with specific requirements which the plaintiff must satisfy before an injunction will issue.[27] The requirements are that: 1) the plaintiff has shown a strong probability of success on the merits; 2) the plaintiff will suffer irreparable injury absent an injunction; and 3) the public

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demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than the day before maturity of any acceptance made under the credit.

Id.

20. *Id.* § 5-114(2).

21. *See, e.g.*, Werner Lehara Int'l, Inc. v. Harris Trust & Sav. Bank, 484 F. Supp. 65, 73 (W.D. Mich. 1980); Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 9 (S.D.N.Y. Mar. 30, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 8, 10 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979).

22. T. QUINN, U.C.C. COMMENTARY AND LAW DIGEST § 5-101 [A][1][a] (1978).

23. N.Y. U.C.C. § 5-102(4) (McKinney). *See* INTERNATIONAL CHAMBER OF COMMERCE, THE UNIFORM CUSTOMS AND PRACTICES ACT (publication no. 290, 1974 version) *reprinted in* T. QUINN, *supra* note 22, § 5-117[D].

The U.C.C. is not a federal statute and must be adopted by a state (which may amend any section of the Code) before it has the force of law. J. WHITE & R. SUMMERS, *supra* note 1, § 1.

24. *See* T. QUINN, *supra* note 22, § 5-101[A][1][a].

25. American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 10 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979).

26. *Id.* at 9-10.

27. Werner Lehara Int'l, Inc. v. Harris Trust & Sav. Bank, 484 F. Supp. 65, 72-76 (W.D. Mich. 1980).

interest will be served by the issuance of an injunction.[28] In deciding injunction against honor cases, the courts concentrate almost exclusively on the public interest requirements.[29] The factors which are weighed in the public interest test are the need to protect an innocent plaintiff from being defrauded by an unscrupulous beneficiary on the one hand, and the need to protect the independence of the issuer's obligation from the underlying transaction on the other.[30]

II. *THE CIRCUMSTANCES UNDER WHICH HONOR HAS BEEN ENJOINED—FRAUD IN THE UNDERLYING TRANSACTION*

The landmark 1941 *Sztejn* case[31] still remains the guiding light for courts in deciding injunction against honor cases.[32] A more recent case, *United Bank Ltd. v. Cambridge Sporting Goods Corp.*,[33] is quite similar to *Sztejn*. In *United Bank* a New York buyer ordered 27,000 leather boxing gloves from a Pakistani seller. The seller was the beneficiary of a letter of credit which was issued by the buyer's bank and was payable upon specified documentation. The gloves which were shipped were unpadded, ripped, badly mildewed and definitely not what the buyer ordered. The Pakistani seller nonetheless provided the bank with the specified documents and demanded payment.[34] The court stated that, although mere breach of warranty was not sufficient to enjoin payment and the line between objections based on the quality of goods and objections based on fraud was sometimes thin, the worthless fragments of leather which the beneficiary shipped evidenced fraud rather than breach of warranty.[35] Therefore, the court enjoined the bank from honoring its letter.[36]

Dynamics Corp. of America v. Citizens & Southern National Bank[37] is another case in which honor was enjoined. In this case

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28. *Id.*
29. *See, e.g.*, notes 45-51 *infra* and accompanying text.
30. *Id.*
31. Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 30 N.Y.S.2d 631 (Sup. Ct. 1941).
32. *See* note 14 *supra*.
33. 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976).
34. *Id.* at 255-57, 360 N.E.2d at 946-48, 392 N.Y.S.2d at 268-70.
35. *Id.*
36. *Id.* at 257, 360 N.E.2d at 947, 392 N.Y.S.2d at 269.
37. 356 F. Supp. 991 (N.D. Ga. 1973).

the government of India was purchasing equipment from Dynamics. A standby letter of credit,[38] issued by Dynamics' bank, was payable to India upon receipt by the issuer of a document signed by the Indian President stating that Dynamics had defaulted on its obligations under the contract. War between India and Pakistan broke out.[39] As a result of a United States embargo, India claimed that there was no delivery (which was a breach by Dynamics) and presented the issuer with the documents required under the letter. Dynamics, then bankrupt, claimed that India's demand for payment was fraudulent because the contract provided for delivery at Dynamics' plant, and the goods were so tendered. The court found that these facts were sufficient grounds to enjoin the bank from honoring its letter.[40]

It is questionable whether fraud existed at all in the *Dynamics* case. Certainly the beneficiary in *Dynamics* was not guilty of committing the grave and intentionally fraudulent acts which were committed by the beneficiaries in *Sztejn* and *United Bank*.[41] Most surprising in the *Dynamics* case is the court's statement that the fraud necessary for an injunction against honor need not be intentional.[42] Fraud, according to the *Dynamics* court, has a broad meaning when the action is in equity and includes "all acts, omissions and concealments which involve a breach of a legal or equitable duty . . . ."[43]

This broad, "equitable" standard is a questionable step away from the long standing independent contracts rule[44] as it sanctions injunctive relief where the beneficiary's behavior might be more properly characterized as defective performance in the underlying transaction. If this broader interpretation of fraud is adopted by the courts, an injunction against honor action could be used as a device

38. *See* note 1 *supra*.

39. *See* 356 F. Supp. at 994; N.Y. Times, Dec. 1, 1971, at 3, col. 1.

40. 356 F. Supp. at 1000.

41. *See* notes 14-18 & 33-35 *supra* and accompanying text.

42. 356 F. Supp. at 998 (quoting S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193-94 (1963)). Courts of equity have long used the term "fraud" to encompass several types of malfeasance. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86 (4th ed. 1971). Nevertheless, considering the independent contracts rule that an issuer's obligation be independent from the underlying transaction, the issuer should only be enjoined when the fraud is "intentional and egregious." Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596, 596 (1978).

43. 356 F. Supp. at 998-99.

44. *See* notes 9-14 *supra* and accompanying text.

for litigating breach of the underlying contract. Such a result would severely weaken the independence of contracts rule, and thus, the utility of the letter of credit as a certain and reliable tool for facilitating complex commercial transactions would be dramatically diminished.

A Pennsylvania court, in *Intraworld Indus. Inc. v. Girard Trust Bank*,[45] did not follow this broad "equitable" standard but rather set forth a well-reasoned policy of granting injunctions in only those situations where the wrongdoing (fraud) of the beneficiary has "so vitiated the entire transaction" that the legitimate purposes of the independence of the issuer's obligation would no longer be served.[46] The *Intraworld* court stated "[a] court of equity has the limited duty of guaranteeing that the beneficiary not be allowed to take unconscientious advantage of the situation and run off with the plaintiff's [customer's] money . . . [upon documentation supplied to the issuer] which has absolutely no basis in fact."[47]

In this Pennsylvania case, a standby letter of credit was payable to the beneficiary upon the issuer's receipt of a statement made by the lessor-beneficiary prescribing that the lessee-customer had not paid the rent due on a resort hotel lease. When the issuing bank received this statement from the beneficiary, the lessee-customer, claiming that all the rent had been timely paid, sought to enjoin the bank from making payment.[48] In affirming the decision below denying injunctive relief, the court stated that the situation was strictly a contract dispute which, according to the independence of contracts rule, should have no effect on the issuer's payment obligation.[49]

In *Intraworld* the court clearly defined the situations which warrant an injunction against honor. The court perceived that the certainty which flows from the independence of the issuer's obligation from the underlying transaction gives the letter of credit its utility.[50] The court believed that it should only interfere in a letter of credit transaction (by prohibiting an issuer from making pay-

45. 461 Pa. 343, 336 A.2d 316 (1975).

46. *Id.* at 359, 336 A.2d at 324-25.

47. *Id.* at 359, 336 A.2d at 325 (quoting Dynamics Corp. of America v. Citizens & S. Nat'l Bank, 356 F.2d 991, 999 (N.D. Ga. 1973)).

48. *Id.* at 345-48, 336 A.2d at 318-21.

49. *Id.* at 358-59, 336 A.2d at 324-25.

50. *Id.* at 357, 336 A.2d at 323.

ment) when the beneficiary has acted in such a reprehensible manner in the underlying transaction that allowing him to receive payment under the letter would be unconscionable.[51] Courts then, should be able to point to fraudulent conduct of the beneficiary in the underlying transaction which would "shock the conscience" before it enjoins honor.

United Bank Ltd. v. Cambridge Sporting Goods Corp.[52] and *Sztejn v. J. Henry Schroder Banking Corp.*[53] provide examples of such "conscience-shocking" fraud.[54] Of the various approaches taken by courts in injunction against honor litigation (in which active fraud is alleged) the view which best preserves the integrity of letter of credit transactions is one which only enjoins honor upon proof that the fraud perpetrated is "reprehensible." Exceptions should be made to the independent contracts rule only when enforcement of this rule would be unconscionable.

III. *PROSPECTIVE FRAUD: THE IRANIAN REVOLUTION AND INJUNCTIONS AGAINST HONOR*

At the time of the Iranian revolution, United States companies had billions of dollars in contracts outstanding with the Iranian government and its agencies.[55]

In the typical situation the Iranian Government—purchaser of equipment or services—would have made an advance payment to the United States contractor.[56] In return, the Iranian purchasers would demand a guarantee of repayment of the advance as well as a performance guarantee equal to ten percent of the amount of the contract.[57] These guarantees, made by Iranian banks, were payable to the Iranian purchasers upon the guarantor's receipt of the Iranian purchaser's statement that the United States contractor had defaulted.[58] The Iranian (guarantor) bank required that the United

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51. *Id.* at 359, 336 A.2d at 324-25.

52. 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976).

53. 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).

54. *See* notes 14-18 & 33-35 *supra* and accompanying text.

55. Rendell, *supra* note 6, at 73.

56. *E.g.*, KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 12-13 (2d Cir. 1979); *see* Rendell, *supra* note 6, at 73.

57. United Technologies Corp. v. Citibank, N.A., 469 F. Supp 473, 475-77 (S.D.N.Y. 1979); Watkins-Johnson Co. v. Wells Fargo Bank, No. C79-0121 SAW, slip op. at 1-2 (N.D. Cal. Feb. 27, 1979); Rendell, *supra* note 6, at 73.

58. *See, e.g.*, KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 12-13 (2d Cir. 1979); *see* Rendell, *supra* note 6, at 73, 75.

States contractor have a United States bank issue a standby letter of credit[59] with the Iranian bank as the beneficiary.[60] The letter was payable upon a declaration by the guaranteeing Iranian bank that it had been called upon to make payment to the Iranian purchaser under the guarantee.[61] The United States issuer-bank, as in all letter of credit situations,[62] would obtain an indemnification from its customer, the United States contractor.[63]

As the revolutionary Iranian Government was so anti-American the United States contractors feared that either the Iranian (guarantor) banks would call for payment of the letters without receiving a demand for payment under the guarantee or that the Iranian purchasers would demand the guarantee payment despite the fact that the United States contractor had not defaulted.[64] If payment under the letter of credit were made, the United States contractor would have to indemnify its bank. Since it was customary for the underlying United States-Iranian contract to provide that Iranian law governed the transaction and that disputes were to be resolved by Iranian courts,[65] the United States contractor's only recourse would be to sue the Iranian bank or Iranian purchaser in an Iranian Court. Seeking to avoid litigation in Iran, the United States contractors petitioned the United States' courts to prohibit their banks from making payment under the letters of credit.[66] They argued that due to the political chaos and anti-American sentiment in Iran, there was a strong likelihood that the guarantees and letters of credit would be fraudulently called.[67]

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59. *See* note 1 *supra*.

60. *See, e.g.* KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 12-13 (2d Cir. 1979); *see Rendell, supra* note 6, at 73, 75.

61. Rendell, *supra* note 6, at 73. The amount of the letter would correspond to the amount of the guarantee. *Id.*

62. *See* note 1 *supra*.

63. Rendell, *supra* note 6, at 73.

64. *See, e.g.*, KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 12-13 (2d Cir. 1979); *see* Rendell, *supra* note 6, at 73, 75.

65. *See, e.g.*, American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 2 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979).

66. *See, e.g.*, United Technologies Corp. v. Citibank, N.A., 469 F. Supp. 473, 474 (S.D.N.Y. 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 2 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979). These United States contractors included such corporate giants as A.T. & T., Pan Am. and United Technologies. Rendell, *supra* note 6, at 73.

67. *See, e.g.*, Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 9 (S.D.N.Y. Mar. 30, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover

Typically, the letter of credit was payable to the Iranian (guarantor) bank upon the United States bank's receipt of a statement from the Iranian bank prescribing that the Iranian bank had been called upon by the "Imperial Government of Iran" to make payment under the guarantee.[68] The United States contractors alleged that, as the "Imperial Government of Iran" no longer existed, any demand by the Iranian (guarantor) bank for payment under the letter of credit would necessarily be legally insufficient.[69] The courts, in rejecting this reasoning, stated that the United States recognition of the present government of Iran as the de jure government is binding on the courts and therefore the present government of Iran succeeded to the rights and position of the former Imperial Government.[70]

As it was reported that many of the Iranian banks were closed and their books and records were destroyed, the United States contractors also argued that there was a substantial risk that any demand by the Iranian (guarantor) bank would be improper and fraudulent and, as such, the United States banks should be enjoined from honoring their letters.[71] The United States contractors stated specifically that, although the Iranians had not yet demanded payment under the letters of credit, the situation in Iran was chaotic, and "unauthorized persons" might gain control of Iranian banking institutions and fraudulently demand payment of the letters of credit.[72] This chaotic situation amounted to "prospective

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Trust Co., No. 3157/79, slip op. at 5 (Sup. Ct. N.Y. Co., Mar. 26, 1979). *See also* Rendell, *supra* note 6, at 73-75.

68. *See, e.g.*, Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 9 (S.D.N.Y. Mar. 30, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 5 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979). *See also* Rendell, *supra* note 6, at 73-75.

69. *See, e.g.* Watkins-Johnson Co. v. Wells Fargo Bank, No. C79-0121, slip op. at 5-6 (N.D. Cal., Feb. 27, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 4-5, 11 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979). *See*

70. *See, e.g.*, Watkins-Johnson Co. v. Wells Fargo Bank, No. C79-0121, slip. op. at 5-6 (N.D. Cal., Feb. 27, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 4-5, 11 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979). *See also* Letter of Secretary of State Muskie to Prime Minister Rajai (Aug. 28, 1980), *reprinted in* N.Y. Times, Sept. 10, 1980, at A8, col. 1.

71. *See, e.g.* KMW Int'l v. Chase Manhattan Bank, N.A., 606 F.2d 10, 13-19 (2d Cir. 1979). *See* Rendell, *supra* note 6, at 73, 75.

72. *See, e.g.*, Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 5 (S.D.N.Y. Mar. 30, 1979); United Technologies Corp. v. Citibank, N.A., 469 F. Supp. 473, 479 (S.D.N.Y. 1979).

fraud," according to the United States contractors, and thus grounds for an injunction against honor were present.[73] The courts, however, responded unsympathetically to this argument and stated that mere suspicion and general apprehension that a demand will be fraudulent are not sufficient causes for an injunction against honor.[74]

A federal district court in *Pan American Airways Inc. v. Bank Melli Iran*[75] looked to the 1941 case of *Nadler v. Mei Loong Corp. of China, Ltd.*[76] when it decided this "speculative fraud issue" and stated that it must be shown that the demand by the beneficiary will necessarily be fraudulent in order for a court to enjoin honor.[77]

In the *Nadler* case New York purchasers of furs from Chinese fur exporters had Manufacturers Trust Company issue a commercial letter of credit in favor of the Chinese seller's New York agent. The agent presented bills of lading and other documents called for under the letter to Manufacturers Trust Company. Although the beneficiary (the Chinese seller's agent) had not yet demanded payment under the letter of credit, the New York purchasers sought to enjoin Manufacturers Trust Company from honoring the drafts. They argued that, as a result of the United States and Japanese war embargoes, it was not possible for the goods to be shipped as the drafts stated and therefore, any documents presented to the bank would necessarily be fraudulent.[78] The court agreed, and prohibited Manufacturers Trust Company from making payment under the letter.[79]

The courts in the Iranian letter of credit cases wisely rejected the prospective fraud argument—that honor should be enjoined because there was a substantial risk that a demand for payment

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73. *See, e.g.*, Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 5 (S.D.N.Y. Mar. 30, 1979); United Technologies Corp. v. Citibank, N.A., 469 F. Supp. 473, 478-79 (S.D.N.Y. 1979); *see* Rendell, *supra* note 6, at 73-75.

74. Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 9-11 (S.D.N.Y. Mar. 30, 1979); Watkins-Johnson Co. v. Wells Fargo Bank, No. C79-0121, slip op. at 6 (N.D. Cal. Feb. 27, 1979); American Bell Int'l, Inc. v. Manufacturers Hanover Trust Co., No. 3157/79, slip op. at 8-9 (Sup. Ct. N.Y. Co., N.Y. Mar. 26, 1979).

75. No. 48411 (S.D.N.Y. Mar. 30, 1979).

76. 177 Misc. 263, 30 N.Y.S.2d 323 (Sup. Ct. 1941).

77. Pan Am. World Airways, Inc. v. Bank Melli Iran, No. 48411, slip op. at 9-13 (S.D.N.Y. Mar. 30, 1979).

78. 177 Misc. at 264, 30 N.Y.S.2d at 323.

79. *Id.* at 264-68, 30 N.Y.S.2d at 323.

would be fraudulent. If a United States court did enjoin an issuer from honoring its letter, not as a result of a fraudulent act committed by the beneficiary, but due to a fraudulent act the court thinks that the beneficiary might commit, foreign merchants would be very wary about requesting a letter of credit from a United States bank.[80] This result would, of course, be very damaging to the United States banking and business communities.[81] The courts can avoid this result by enjoining honor only in those situations (in which the argument of prospective fraud is raised) where the facts are such that, although no demand for payment under the letter by the beneficiary has been made, any demand in the future would "necessarily be fraudulent."

CONCLUSION

The utility of the letter of credit in facilitating complex international and domestic commercial transactions stems from the independence of the issuer's obligation to the beneficiary from the underlying transaction. If the letter of credit is to retain its utility, the situations in which a court prohibits the issuer from making

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80. Gibbs & Hill, Inc. v. Chemical Bank, No. 03637/79, slip op. at 12 (Sup. Ct. N.Y. Co., N.Y. June, 1979).

> [T]here is insufficient reason to, in effect, discredit the international letter of credit . . . in this jurisdiction. It might well develop—if banks in this jurisdiction are readily restrained from honoring irrevocable letters of credit—that other foreign nations and corporations will insist that any letters of credit issued in the course of trade be issued by a bank from a jurisdiction other than New York. This could have a most serious effect on the world's major banking center and is an additional factor to be considered in balancing the equities.

Id.

81. *Id.* One student commentator has suggested that injunctions should have been granted in the Iranian letter of credit cases where the government of Iran was the beneficiary. Comment, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L L.J. 189, 246 (1980). The rationale for this pro-injunction argument was that "prospective losses due to a sovereign's breach of its duty of state responsibility to aliens are not assumed by the bank customers and should provide for an injunction against honor." *Id.* This analysis entirely omits to consider the situation of the issuing bank if an injunction is granted. If the bank's international letters of credit were enjoined by a United States court, the bank would nevertheless be subject to liability under the letters in foreign jurisdictions where it has assets. More importantly, the bank's reputation for commercial honor would be severely damaged when foreign nationals learned that the United States issuing bank was enjoined because of a "political situation" outside the United States.

payment under the letter must be very carefully and narrowly drawn.

In the cases where the customer seeks an injunction against honor due to the beneficiary's fraudulent conduct in the underlying transaction, the courts should grant injunctions only where the beneficiary's conduct is so reprehensible that it would shock the conscience of any reasonable person. In the cases where the customer seeks to enjoin honor on the grounds of prospective fraud, the courts should only grant injunctive relief where a future demand for payment under the letter of credit by the beneficiary would necessarily be fraudulent.

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