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## COMMERCIAL LAW: The Immunization of Fraudulently Procured Letter of Credit Acceptances: *All Services Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus do Brazil, S.A.* and *First Commercial v. Gotham Originals*

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THE IMMUNIZATION OF FRAUDULENTLY  
PROCURED LETTER OF CREDIT ACCEPTANCES:  
*ALL SERVICES EXPORTACAO, IMPORTACAO  
COMERCIO, S.A. v. BANCO BAMERINDUS DO  
BRAZIL, S.A.\* AND FIRST COMMERCIAL v.  
GOTHAM ORIGINALS\*\**

*Boris Kozolchyk\*\*\**

INTRODUCTION

The combination of black beans, fraud and Chicago and New York banks has had a destabilizing effect on contemporary letter of credit law.<sup>1</sup> The latest destabilization involves the unavailability of injunctions against payment to a possibly fraudulent letter of credit beneficiary.<sup>2</sup> All too often courts have granted injunctions where they are not warranted and, by so doing, have frustrated good faith beneficiaries' reasonable expecta-

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\* 921 F.2d 32 (2d Cir. 1990).

\*\* 64 N.Y.2d 287, 475 N.E.2d 1255, 486 N.Y.S.2d 715 (1985).

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<sup>1</sup> Almost a decade ago, Milton Shadur, one of our most thoughtful judges, gave some consideration to enabling a Guatemalan applicant to sue a Chicago confirming bank with whom the applicant had not dealt. What prompted Judge Shadur's consideration of the applicant's action was the confirming bank's seemingly grossly negligent payment against documents that fraudulently attested to the shipment of black beans to Guatemala. A document appeared to bear a date of presentation to the bank that should have provided a glaring indication of fraud or forgery. On rehearing it appeared that the evidence reflected a wrong date of presentation and consequently no negligence was attributable to the confirming bank. See *Instituto Nacional de Comercializacion Agricola v. Continental Bank & Trust Co.*, 530 F. Supp. 279 (N.D. Ill. 1982).

<sup>2</sup> This issue continues to concern courts, legislators and commentators. See Task Force on the Study of U.C.C. Article 5, *An Examination of U.C.C. Article 5*, 45 Bus. Law. 1521 (1990) [hereinafter *Task Force Report*].

tions of payment. The certainty of payment of a letter of credit is crucial for those who, as beneficiaries, supply their money, goods or services to applicants. The question thus arises: "Why not make the letter of credit draft or demand for payment injunction-proof?" Yet what about the applicant? To leave the applicant without a remedy against fraud would equally frustrate the applicant's expectations of the letter of credit. After all, why should a good faith applicant agree to procure the issuance of a letter of credit and reimburse the issuing bank if the letter of credit becomes an automatic and unstoppable vehicle for the perpetration of fraud? As is true with other commercial legal institutions, an approach that favors one party at the expense of the other undermines the viability of the institution. The question then is how to achieve an acceptable balance of equities. More specifically, under what conditions, if any, should equitable remedies be available to applicants?

While considerable doubt remains among courts and commentators on the type of fraud that should warrant injunctive relief,<sup>3</sup> the legislature ostensibly has settled the matter by enacting U.C.C. section 5-114. Section 5-114 immunizes against a fraud-based injunction "a negotiating bank or other holder of the draft or demand which has taken the draft or demand . . . under circumstances which could make it a holder in due course."<sup>4</sup> Accordingly, section 5-114 precludes injunctions

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<sup>3</sup> See *id.*

<sup>4</sup> U.C.C. § 5-114(2)(a) & (b). Sections 5-114(2)(a) & (b) provide that:

(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 certificated 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 certificated 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.

The references to U.C.C. sections in this article will be to versions in force in New York

against a negotiating bank that qualifies as a holder in due course, leaving the beneficiary who did not negotiate his draft vulnerable to a fraud-based injunction. A similar line is drawn by the law of other major financial centers such as in France, Germany, Great Britain and Italy.<sup>5</sup>

Although the legislature has drawn a clear line between the rights of a beneficiary and those of a negotiating bank holder in due course by enacting U.C.C. section 5-114, the Second Circuit has recently blurred this line. In *All Serv. Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus do Brazil, S.A.* ("*Banco Bamerindus*")<sup>6</sup> the Second Circuit affirmed an unreported decision of the United States District Court for the Southern District of New York.<sup>7</sup> *Banco Bamerindus* involved a fraudulent shipment of black beans to Brazil. This unreported decision held that a letter of credit had to be paid by its issuer even though a Brazilian court had enjoined such payment. The draft had not been negotiated by the beneficiary and was in the beneficiary's possession at the time payment was ordered by the district court.

The *Banco Bamerindus* decision represents an unjustified extension of New York law as formulated principally by the New York Court of Appeals in *First Commercial Bank v. Gotham Originals, Inc.* ("*Gotham*").<sup>8</sup> *Gotham* had denied injunctive relief against a bank holder of a beneficiary's drafts because it found that the draft in question had been accepted by the issuing bank, even though the acceptance might have been procured by fraud. First Commercial Bank ("*First Commercial*") (the bank holding the beneficiary's accepted draft) was described by the New York court as having negotiated the beneficiary's draft. This description of First Commercial's status provided a basis for the Second Circuit to distinguish *Banco Bamerindus* and *Gotham*. However, both the district and the Second Circuit *Banco Bamerindus* courts rejected this distinction and noted that the New York Court of Appeals declined to base its deci-

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or other states at the time of the court decisions discussed in the principal text. When more recent versions of the same or amended U.C.C. sections are discussed, they will be identified.

<sup>5</sup> See *infra* notes 153-75 and accompanying text.

<sup>6</sup> 921 F.2d 32 (2d Cir. 1990).

<sup>7</sup> No. Civ. 90-6797, 1990 WL 170343 (S.D.N.Y. Oct. 31, 1990).

<sup>8</sup> 64 N.Y.2d 287, 475 N.E.2d 1255, 486 N.Y.S.2d 715 (1985).

sion upon First Commercial's status as a holder in due course. In rejecting the distinction between a beneficiary and a bank holder of beneficiary's draft (which may or may not become a holder in due course), the Second Circuit read *Gotham* in the light most favorable to the beneficiary. Before *Banco Bamerindus*, a fraudulent beneficiary holding his own accepted time draft was, under U.C.C. section 5-114, subject to the issuing bank's defense of fraud or to an applicant's injunction against payment. After *Banco Bamerindus* such a beneficiary is entitled to payment in the influential Second Circuit and beyond.<sup>9</sup>

Before *Banco Bamerindus*, *Gotham* had already been unduly extended by New York's appellate division and court of appeals in *Supreme Merchandise Co. Inc v. Chemical Bank* ("Chemical")<sup>10</sup> to prevent an attachment of letter of credit funds where the paying bank had accepted the time drafts "prior to the service of the second order of attachment."<sup>11</sup> *Chemical*, in turn, was interpreted by the United States District Court for the Southern District of New York in *Algemene Bank Nederland N.V. v. Soysen Tarim Urumleri Dis Ticaret*<sup>12</sup> as protecting an assignee of beneficiary's proceeds against a judgment creditor, even though the draft had not been accepted in writing or certified as payable by the paying bank.<sup>13</sup> *Banco Bamerindus'* extension of *Gotham* and *Chemical's* immunity to a possibly fraudulent beneficiary holding his own draft after its acceptance by the payor bank completed a protective circle around holders of letter of credit time drafts. Now included in this circle are: negotiating banks that are holders in due course, negotiating banks that do not qualify as holders in due course, assignees of proceeds, good faith beneficiaries and fraudulent or possibly fraudulent beneficiaries.

The New York state and federal courts justified their decisions by arguing that the availability of U.C.C. article 5 injunctions is subject to U.C.C. article 4 rules on finality and priority

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<sup>9</sup> In *Union Export Company v. N.I.B. Intermarket A.B et al.*, 786 S.W.2d 628, 630-32 (Tenn. 1990), the Supreme Court of Tennessee adopted not only *Gotham's* holding but also its policy considerations.

<sup>10</sup> 117 A.D.2d 424, 503 N.Y.S.2d 9 (1st Dep't), *aff'd*, 70 N.Y.2d 344, 514 N.E.2d 1358, 520 N.Y.S.2d 734 (1986).

<sup>11</sup> *Id.* at 425, 503 N.Y.S.2d at 10.

<sup>12</sup> 748 F. Supp. 177 (S.D.N.Y. 1990).

<sup>13</sup> *Id.* at 181.

of payment. This reasoning assumes that a beneficiary who holds an accepted time draft, regardless of how broadly "acceptance" is defined, receives final payment of the letter of credit or is inevitably entitled to such payment from the moment the acceptance is issued. Such reasoning also assumes that although a letter of credit accepted time draft is neither deposited nor submitted for collection in a manner consistent with U.C.C. article 4, it is nevertheless subject to this article.

Since New York is both a national and world center of letter of credit issuances, confirmations, acceptances, negotiations and payments, *Gotham* and *Banco Bamerindus* are likely to disrupt national and international letter of credit law and practice. A New York confirming bank forced to pay and to ignore the foreign court injunction will, in all likelihood, be denied reimbursement by the foreign issuing bank subject to the foreign court injunction. If the New York confirming bank reimburses itself by debiting the account of the foreign bank, the New York bank's account with the foreign issuing bank will be similarly debited by the foreign correspondent bank. In this respect, *Gotham* and *Banco Bamerindus* add uncertainty to the considerable distrust that presently plagues the issuing-confirming bank relationships.<sup>14</sup> This distrust often results in the confirming bank's costly requirement of prepayment or full collateralization of its confirmation.

By reinforcing the need for prepayment and full collateralization, *Banco Bamerindus* and *Gotham* discourage the extension of credit among correspondent banks, one of the most significant benefits of correspondent banking relationships. In addition, foreign beneficiaries faced with a fraud-based injunction at their place of business are likely to bypass their confirming banks and present their documents directly to the issuing bank in New York. In time, banks within the Second Circuit's jurisdiction will become known as issuers of fraud-proof time letters of credit. Actual or potential fraudsters will find this feature desirable, as will some good faith beneficiaries who fear their buyers' bad faith injunctions. Yet good faith applicants aware of their beneficiaries' fraud and foreign banks caught between contradictory judicial orders will find the fraud-injunc-

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<sup>14</sup> See Boris Kozolchyk, *Strict Compliance and The Reasonable Document Checker*, 56 BROOK. L. REV. 45, 47-49 (1990).

tion-proof time drafts unacceptable.

Equally important are the decisions' implications for the act of state and comity doctrines. Banks' willingness to act as correspondents for international letter of credit transactions presupposes a level international legal "playing field." The playing field is not level, however, when beneficiaries in one jurisdiction enjoy an upper hand over the applicants of another. Contrary to the act of state and comity doctrines, bank "A" in country "Y" will now be compelled to pay while bank "B" in country "Z" will be under a similar order not to pay when faced with the same exact set of facts. *Gotham's* and *Banco Bamerindus's* impact upon the act of state and comity doctrines is serious enough to merit careful analysis. Nevertheless, the complexity and far ranging effects of the U.C.C article 4 and 5 issues raised by these decisions is such that this Article will only be able to focus on these issues and not on the act of state and comity issues.

## I. BACKGROUND: PAYMENT AND FINAL PAYMENT OF CHECKS AND OF INTERNATIONAL LETTERS OF CREDIT

### A. *U.C.C. Articles 4 and 5 Generally*

While an article 4 transaction usually involves the payment of a check, the payment addressed by article 4 generally is not a direct payment by the drawee bank to the original payee. Rather, payment is usually by the drawee to an intermediary collecting bank.<sup>15</sup> Commonly the check is deposited by the original payee or subsequent endorsee with a depositary bank. The depositary bank may attempt to collect the check itself by presenting it directly to the drawee bank or may send the check for collection to another bank, known as a collecting bank. The collecting bank may, in turn, present the check directly for payment to the drawee bank or it may do so indirectly through an-

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<sup>15</sup> See FREDERICK K. BEUTEL & MILTON R. SCHROEDER, *BANK OFFICER'S HANDBOOK OF COMMERCIAL BANKING LAW* 365-75 (1982). These authors find it necessary to remind the reader that:

at common law when an instrument was drawn or made payable on a bank in a city which had two or more banks, the paper was required to be sent to one other than the drawee or payor. If the instrument was sent directly to the drawee for collection, any loss resulting from failure of the proceeds to be returned fell to the bank sending the instruments, on the theory that it was improper to ask a bank to collect from itself . . . .

*Id.* at 368.

other collecting bank, which presents the check to the drawee bank at a local or regional clearinghouse.<sup>16</sup>

Unlike article 4 checks, an article 5 letter of credit draft is usually paid *directly* to its payee-beneficiary by any one of several banks. As a rule the letter of credit itself is drawn by an issuing or confirming bank and is payable by these banks against presentation of a draft or demand for payment drawn by the beneficiary accompanied by the documents specified in the letter of credit. Generally the issuing bank is located in the applicant's place of business and the confirming bank in the beneficiary's place of business. If the credit is merely advised and not confirmed, *i.e.*, if it does not engage the advising bank's liability, the draft or demand is presented to the advising bank that forwards the documents for payment to the issuing bank. Advising banks, however, can also pay the draft or demand when they are nominated to act as paying banks by the issuing or confirming banks.

Some credits do not nominate a specific bank to pay or to negotiate the beneficiary's draft, but authorize any bank to negotiate the beneficiary's draft. The authorization is in the form of a clause enabling acceptance or payment to a *bona fide* holder of a beneficiary's draft. A credit that contains such an authorization is known as a negotiation credit. A negotiation credit does not allow for the negotiation of the credit because credits, unlike drafts, are not negotiable. They are only transferable.<sup>17</sup>

A transferable credit is one that allows a transferee to present a draft or demand for payment accompanied by specified documents, as if the transferee were a beneficiary, subject only to terms and conditions of the transfer.<sup>18</sup> As a rule the original

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<sup>16</sup> Beutel and Schroeder provide the following illustration of a typical collection process:

A buyer from Champaign, Illinois, may give a check drawn on a Champaign bank to a merchant in Winnetka. The merchant will deposit the check in his Winnetka bank, the Winnetka bank may then send it through clearings to its Chicago correspondent bank, the Chicago correspondent will send it to a second Chicago bank that is a correspondent of the Champaign drawee bank, and the second Chicago bank will then send the paper to the Champaign bank. (When all or some of the banks are members of a common clearinghouse, the numbers of banks needed to handle the instruments may be reduced).

BEUTEL & SCHROEDER, *supra* note 15, at 368-69.

<sup>17</sup> See Boris Kozolchik, *Letters of Credit*, in INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 33 (1978).

<sup>18</sup> *Id.*



beneficiary retains a portion of the credit and transfers the remaining portion. To be transferred, the credit must be labeled "transferable." In addition, a transferable credit is subject to restrictions with respect to the contents of some of the documents and to the number of total transfers. When a negotiating bank purchases an original beneficiary's or a transferee's draft and does so without recourse against the beneficiary or the transferee, where the beneficiary and transferee are concerned, the negotiating bank has paid the credit.

### B. *The Final Payment of Checks*

The *Banco Bamerindus* and *Gotham* courts assumed that the U.C.C. article 4 rules on finality of payment and unavailability of injunctions applied equally to article 4 and article 5 acceptances and payments. Since this assumption is central to the courts' reasoning, it deserves scrutiny. First, it is necessary to inquire whether article 4 applies to *Banco Bamerindus* and *Gotham* time drafts. As indicated earlier, an article 4 check ordinarily undergoes provisional settlements and clearings before final payment by the drawee bank. Each provisional settlement in the collection chain is a form of temporary payment.

Article 4 resorted to the notion of "final payment" to firm up or to add finality to provisional settlements, thereby facilitating the process of clearance and reciprocal debits and credits among banks that participate in the collection and payment chain.<sup>19</sup> At times, the acts of final payments are apparent to the

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<sup>19</sup> In relevant part, U.C.C. section 4-213 states:

(1) An item is finally paid by a payor bank when the bank has done any of the following, whichever happens first:

- (a) paid the item in cash; or
- (b) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement; or
- (c) completed the process of posting the item to the indicated account of the drawer, maker or other person charged therewith; or
- (d) made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing house rule or agreement.

Upon final payment under subparagraphs (b), (c) or (d) the payor bank shall be accountable for the amount of the item.

(2) If the provisional settlement for an item between the presenting and payor banks is made through a clearing house or by debits or credits in an account between them, then to the extent that provisional debits or credits for the

collecting bank or payee of the check. This is the case when a collecting bank receives a wire transfer from a drawee bank for the amount of the check or when the payee of the check receives a cash payment from the same bank.<sup>20</sup> Other times, however, the act of final payment is not apparent either to the collecting bank, the payee or the check depositor. Such is the case when a drawee bank completes the process of posting the check or when this bank fails to revoke a provisional settlement in the time and manner "permitted by statute, clearing house rule or agreement."<sup>21</sup> As creatures of a bank clearing and settlement process, these bookkeeping transactions do not reflect what a non-bank payee understands by final payment. To such a payee, final payment means "cash in my pocket"<sup>22</sup> and not a mere bookkeeping

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*item are entered in accounts between the presenting and payor banks or between the presenting and successive prior collecting banks seriatim, they become final upon final payment of the item by the payor bank.*

*Id.* (emphasis added). As stated by U.C.C. section 4-213 comment 1:

Final payment of an item is important for a number of reasons. It is one of the several factors determining the relative priorities between items and notices, stop orders, legal process and set offs (Section 4-303). It is the "end of the line" in the collection process and the "turn around" point commencing the return flow of proceeds. *It is the point at which many provisional settlements become final.*

*Id.* (emphasis added). As stated in an early and still insightful commentary to article 4: Receipt and final payment by the last of the collecting banks renders irrevocable all conditional credits granted by each of the banks in the collection chain to its immediate transferor, including the credit granted to the customer of the depository bank. The collection process is thereby terminated, the customer becoming an absolute creditor of the next succeeding bank.

See Note, *The Proposed Uniform Commercial Code: Bank Deposits and Collections*, 50 COLUM. L. REV. 802 (1950).

<sup>20</sup> For the "media of remittance" or of payment of items, see U.C.C. section 4-211, which, in relevant part states:

- (1) A collecting bank may taken in settlement of an item
  - (a) a check of the remitting bank or of another bank on any bank except the remitting bank; or
  - (b) a cashier's check or similar primary obligation of a remitting bank which is a member of or clears through a member of the same clearing house or group as the collecting bank; or
  - (c) appropriate authority to charge an account of the remitting bank or of another bank with the collecting bank; or
  - (d) *if the item is drawn upon or payable by a person other than a bank, a cashier's check, certified check or other bank check or obligation.*

*Id.* (emphasis added).

<sup>21</sup> See the text of U.C.C. § 4-213(1)(b) & (c), *supra* note 20.

<sup>22</sup> This writer owes to E. Adamson Hoebel, the great legal anthropologist, the "cash in my pocket" expression. Hoebel attributes the phrase to a Pueblo Indian who was

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Recognizing that funds which pay for checks can earn interest to the payor banks at the expense of other banks and their customers, bank regulators have from time to time sought to limit the time within which the payor must pay or dishonor. This time limit is referred to in article 4 parlance as the "midnight" deadline.<sup>23</sup>

The article 4 firming up of provisional settlements also requires protection against last minute interferences by actual or potential creditors. These interferences occur: (1) by judicial actions to prevent payments; (2) by judicial sequestration or attachment of funds; (3) by customers' actions to stop payment; or (4) by payor banks to setoff their claims against payees. Banking lawyers refer to these interferences as the "four legals."<sup>24</sup> After listing these interferences, U.C.C. section 4-303 also lists the acts that bar the interference because it "came too late."<sup>25</sup> While sec-

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asked what kind of final payment he wanted from a United States government entity and responded in the quoted fashion.

<sup>23</sup> U.C.C. section 4-104(h) provides: "Midnight deadline' with respect to a bank is midnight on its next banking day following the banking day on which it receives the relevant item or notice or from which the time for taking action commences to run, whichever is later . . . ." *Id.*

For an interesting description on how the drafters arrived at the notion of a midnight deadline, see J. Fairfax Leary, *Reflections of a Drafter: J. Fairfax Leary*, 43 OHIO ST. L. J. 557 (1982). Leary stated that first the drafters tried "a day blockage" i.e., in posting checks the bank had to post checks in order of arrival. Checks that came on Monday had to be posted before the checks that came on Tuesday. Following the Second World War, the deferred posting rule was adopted. Under this rule, instead of having to pay or dishonor the check before close of the business day on the day in which it was presented, banks were given until midnight of the day after, if a provisional settlement was made on the day of receipt. In Leary's words: "Bank lawyers did not like the day blockage, so we invented something called the midnight deadline. And up until and through the spring 1950 draft that was the basic cutoff point for priorities and for when the check was finally paid." *Id.* at 561 (emphasis added).

<sup>24</sup> The expression "four legals" refers to the "knowledge or notice of the customer's death, incompetency or bankruptcy, the customer's stop-order, legal process, such as an injunction, attachment or garnishment, and setoff by the payor-bank. These are listed in U.C.C. § 4-303(1). See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 803 (3d ed., 1988).

<sup>25</sup> U.C.C. section 4-303 provides:

(1) Any knowledge, notice, or stop order received by, legal process served upon or set off exercised by a payor bank, whether or not effective under other rules of law to terminate, suspend or modify the bank's right or duty to pay an item or to charge its customer's account for the item, comes too late to so terminate, suspend or modify such right or duty if the knowledge, notice, stop order or legal process is received or served and a reasonable time for the bank to act

tion 4-303 was clearly intended for the protection of provisional settlements and clearings, it did not immunize payments to fraudulent payees of "accepted" drafts or checks. Neither did this section protect the payee of the draft or check against the drawee's defenses or against the customer's or applicant's injunction. To begin with, when a drawee bank pays the check directly to the payee and such a payee is not a holder in due course, the drawee bank can raise against the payee "all defenses of any party which would be available in an action on a simple contract."<sup>26</sup> Moreover, as between the drawee bank and the payee with whom the drawee bank has dealt, neither the payment nor the acceptance of the payee's draft is final in the sense that it cannot be recovered by the payor. In accordance with U.C.C. section 3-418, the finality of payment or acceptance can only be claimed by "a holder in due course, or by a person who has in good faith changed his position in reliance on the payment."<sup>27</sup> As the Official Comment to section 3-418 explains:

The section follows decisions under the original Act, in making payment or acceptance final only in favor of a holder in due course, or a transferee who has the rights of a holder in due course under the shelter principle. If no value has been given for the instrument, the holder loses nothing by the recovery of the payment or the avoidance of the acceptance, and is not entitled to profit at the expense of the drawee . . . .<sup>28</sup>

This analysis applies equally to instruments, such as cashiers' checks, which have been treated as cash or as acceptances issued in advance of the presentation of the checks for their pay-

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thereon expires or the setoff is exercised after the bank has done any of the following:

- (a) accepted or certified the item;
- (b) paid the item in cash;
- (c) settled for the item without reserving a right to revoke the settlement and without having such right under statute, clearing house rule or agreement;
- (d) completed the process of posting the item to the indicated account of the drawer, maker or other person to be charged therewith or otherwise has evidenced by examination of such indicated account and by action its decision to pay the item . . . .

*Id.*

<sup>26</sup> U.C.C. §§ 3-306(b) & 3-305(2).

<sup>27</sup> U.C.C. § 3-418.

<sup>28</sup> See U.C.C. § 3-418 cmt. 3.

ment.<sup>29</sup> Usually cashiers' checks are treated as accepted in advance and they "cannot be dishonored by the bank because of an indebtedness to it by one of its customers."<sup>30</sup> An exception is recognized, however, where the payee of the cashier's check deals directly with the payor bank and engages in fraud to obtain the issuance of the check when "the payor bank is entitled to stop payment on the check."<sup>31</sup>

### C. *The Final Payment of Letters of Credit*

Unlike checks, letter of credit drafts, even after they have been accepted, do not become part of settlements and clearing mechanisms. As a rule the collecting bank in the letter of credit collection process sends the draft and documents directly to the issuing or confirming bank or presents them to a nominated paying bank.<sup>32</sup> None of the banks that act as intermediaries in the

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<sup>29</sup> See *Anderson, Clayton & Co v. Farmers National Bank*, 624 F.2d 105 (10th Cir. 1980).

<sup>30</sup> *Id.* at 110, citing *Swiss Credit Bank v. Virginia National Bank*, Fairfax, 538 F.2d 587, 588 (4th Cir. 1976).

<sup>31</sup> *Id.* (citing *TPO, Inc. v. Federal Deposit Insurance Corp.*, 487 F.2d 131 (3d Cir. 1973)). See also *In re Johnson*, 552 F.2d 1072 (4th Cir. 1977); *Wilmington Trust Co. v. Delaware Auto Sales*, 271 A.2d 41 (Del. 1970). But *c.f.* *Da Silva v. Sanders*, 600 F. Supp. 1008, 1010-14 (D.D.C. 1984) (discussing "the two statutory approaches").

<sup>32</sup> It should be noted that under certain circumstances a bank presenting a letter of credit documentary draft for payment may act as an article 4 collecting bank uninvolved in clearings and provisional settlements. For example, a confirming bank may have determined that the draft and documents presented by the beneficiary do not comply with the terms of the credit but may have agreed with the beneficiary to present the documentary draft on a "collection only" basis *i.e.*, as a mere agent for collection from the issuing bank or applicant for the credit. This type of collection, however, is also subject to different rules from those that prevail in an article 5 presentation. The presentment of an article 4 documentary draft can be subject to instructions that require presentment "on arrival of the goods" or "when the goods" arrive. Such instructions are incompatible with an article 5 payment which, in accordance with section 5-114(1), must be made "regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary." U.C.C. § 5-114. In addition, the release of documents is made subject to rules that are similarly inconsistent with letter of credit law and practice. Section 4-503(a), for example, imposes the duty on the presenting bank to deliver "the documents to the drawee on acceptance of the draft if it is payable more than three days after presentment." U.C.C. § 4-503(a). Many instruments sent for international collection are made subject to the International Chamber of Commerce Rules. INTERNATIONAL CHAMBER OF COMMERCE UNIFORM RULES FOR THE COLLECTION OF COMMERCIAL PAPER, Publication 322 (1978). Even though a collection would be subject to these rules, article 4 may be applied where these rules are not inconsistent with it, or where the article 4 rule is mandatory or embodies the public policy of the forum.

process of collecting the letter of credit draft or demand for payment credit or debit their predecessors' or successors' accounts until the issuing or confirming banks decide to pay. As stated earlier, such payment can be made by the issuing or confirming banks themselves or by their correspondents authorized to debit or credit the appropriate accounts. Hence, the specification of a time within which the issuing or confirming bank must honor a beneficiary's draft or demand for payment in letter of credit law and practice is neither the transactional nor the legal equivalent of article 4's "midnight deadline."<sup>33</sup>

Both the Uniform Customs and Practices for Documentary Credits ("UCP")<sup>34</sup> requirement that the issuing bank examine the beneficiary's documents within a "reasonable time" and the U.C.C.'s deferral "until the close of the third banking day following receipt of the documents"<sup>35</sup> reflect a desire to give banks enough time to examine carefully the draft and documents. The examination period also allows a beneficiary the opportunity to cure discrepancies and either resell or reship the goods if the documents are rejected by a bank.<sup>36</sup> The direct contact in the article 5 letter of credit transaction between the beneficiary and the issuing, confirming, paying or negotiating banks explains the difference between a three-day period for examination and payment and a midnight deadline. It will be recalled that article 4's examination and payment period reflect a direct contact primarily between the payor and intermediary banks. The article 4 period also reflects a concern with a quick firming up of provisional settlements and an elimination of the period of uncompensated use of other parties' check funds. Since neither U.C.C. article 5

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<sup>33</sup> See *supra* note 23 and accompanying text.

<sup>34</sup> See Int'l Chamber of Commerce, Publication No. 400, Uniform Customs and Practices for Documentary Credits (1983) [hereinafter *UCP*].

<sup>35</sup> See *UCP*, art. 16; U.C.C. § 5-112(1)(a).

<sup>36</sup> In relevant part, the Official Comment to section 5-112 states:

Many letters of credit involve transactions in international trade and include as required documents the documents of title controlling the possession of goods on their way to the place of issuance of the credit. The ordinary rule requiring physical return of dishonored documentary drafts (Section 4-302) would therefore frequently work commercial hardship on the mercantile parties to the transaction; resale of the goods might be more difficult if the controlling documents of title were not available at the place of arrival of the goods.

U.C.C. § 5-112 cmt. 2.

nor the UCP is concerned with firming up provisional settlements and clearings, neither set of rules contain analogues to article 4 "final payment" or "four legals" provisions.<sup>37</sup> Instead, the UCP and the U.C.C. specify the meaning of the bank's commitment to pay and the instances in which payment is without recourse to the beneficiary.

The issuing or confirming bank's commitment to pay varies with the kind of draft required by the letter of credit. If the letter of credit requires payment upon presentation of a draft drawn on the issuing or confirming bank, the draft is termed a "sight" draft and will be paid as soon as the bank determines that the draft and accompanying documents comply with the terms and conditions of the credit. The meaning of the sight payment in letter of credit customary law, then, is actually to pay the credit or to assure that payment will be made by the designated party.<sup>38</sup> This meaning coincides with the layman's understanding of final payment as "cash in his pocket."<sup>39</sup> The UCP also makes clear that when the payment is made by a negotiating bank, the bank pays "without recourse to drawers and/or bona fide holders of drafts drawn by the beneficiary . . ."<sup>40</sup>

If the letter of credit requires payment at a certain time after the presentation of the draft and documents, it is known as an "acceptance" credit and the draft is known as a "time," "tenor" or "usance" draft. If the draft and documents comply with the terms and conditions of the credit, the bank will accept the beneficiary's draft, thereby promising to pay at a future time. The act of acceptance is affected by the bank's writing or stamping the word "accepted" across the draft's face or on the acceptor's column, and then signing and dating it. It should be noted, however, that the accepting bank's obligation to honor an acceptance is not discharged by merely accepting the draft. As stated in the final draft of the proposed revision of the UCP, to

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<sup>37</sup> See *supra* note 24 and accompanying text.

<sup>38</sup> See Draft, Int'l Chamber of Commerce, Publication 500, Uniform Customs and Practices for Documentary Credits, I.C.C. Doc. No. 470-37/104, art. 10(a) (Sept. 18, 1992) [hereinafter *UCP 500*]. With respect to acceptances, article 10(a) (iii) allows drafts against the applicants and tacitly payments by the same party. The present UCP revision specifies acceptance by the issuing or drawee bank and payment of the acceptance by the issuing bank, directly or indirectly, in the event that the drawee bank does not accept the drafts drawn on it. See *id.*, art. 9(a) & (b).

<sup>39</sup> See *supra* note 22.

<sup>40</sup> See *UCP 500*, *supra* note 38, at art. 10(a)(iv).

honor an acceptance credit the honoring bank must not only accept the draft but, must also pay it at maturity.<sup>41</sup>

Once the issuing or confirming bank accepts a letter of credit draft, its liability on that credit is no longer contingent. It becomes an unconditional liability: the accepting bank has determined that the documents comply with the terms and conditions of the credit and that payment is due on the date specified in the accepted draft. The bank's unconditional acceptance does not mean that the issuing or confirming bank cannot raise defenses against the beneficiary holder of the draft. By accepting the item, the issuing or confirming bank is not limited to post-payment actions such as unjust enrichment or mistaken payment, against the beneficiary. The same rules on availability of defenses discussed previously in connection with checks apply to accepted drafts in the hands of the payee-beneficiary. As a party who has dealt with a beneficiary who is not a holder in due course, the drawee bank can raise defenses such as setoff, accord and satisfaction and beneficiary's consent to post-acceptance amendments, which require additional or modified documents. In addition, U.C.C. section 5-114 expressly leaves it to the bank's discretion to raise the defense of fraud by allowing banks to refuse to honor the allegedly fraudulent draft or demand for payment.<sup>42</sup>

If the mere writing or stamping of an acceptance on a time draft were to entail not only unconditionality, but also finality of payment, letter of credit practice would be significantly changed. As of the moment the issuing bank signified its acceptance, the confirming bank would be able to wipe out its confirmation liability from its books. Conversely, if the confirming bank were the one signifying the acceptance, the issuing bank would have to provide prepayment immediately preceding or reimbursement immediately following the writing or stamping of the acceptance. Since such changes would inevitably lead to unjust enrichment by requiring payment or reimbursement for moneys not paid and not likely to be paid in the immediate future, banks could not adopt them.

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<sup>41</sup> See UCP 500, *supra* note 38, at art. 9(a)(iii). It provides that "if the credit provides for acceptance; a. by the issuing bank - to accept Draft(s) drawn by the Beneficiary on the issuing Bank and pay them at maturity . . . ." *Id.* (emphasis in original).

<sup>42</sup> U.C.C. § 5-114(2)(b).



A changed practice could only have been justified if the issuing and confirming banks were part of an article 4 collection chain and either of them had provisionally settled with the collecting banks before the signification of their acceptance. In other words, the equation between the signification of the acceptance and final payment would be justified if the acceptance were to be used by the accepting-payor bank as *the means with which to pay other banks in the collection chain* for their previous giving of value to the accepting-payor bank. No such justification exists when the acceptance is not used as the means with which to effect *final* payment either to other banks or to the beneficiary. For this reason a letter of credit acceptance in the hands of the drawer of the accepted draft or his agent for collection cannot be deemed as having been finally paid and cannot be treated as cash until it is cash and is in the beneficiary's pocket.<sup>43</sup>

Letter of credit acceptances, however, are often bought or "discounted" by the accepting bank itself or bought in the open market by other banks, investors or speculators. Where the acceptance is bought by a bank or other holder under circumstances that would qualify such a buyer as a holder in due course, payment will be much more certain than if it were to the beneficiary or his agent. As a holder in due course, the negotiating bank is not subject to the issuing or confirming bank's personal defenses against the beneficiary and is also immune to the defense of fraud and to the fraud injunction alluded to in U.C.C. section 5-114.<sup>44</sup>

Sight and acceptance credits are by far the most common types of letters of credit payable against the presentation of drafts. Nevertheless, in the last fifty years of international banking practice, variations have emerged as a result of demands by customers and beneficiaries for more advantageous credit terms and stamp tax avoidance. One of these variations, the "deferred payment" credit, was first used in Japanese Far Eastern trade in the early 1950s and is now widely used in Europe.<sup>45</sup> On its face,

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<sup>43</sup> See *supra* note 22.

<sup>44</sup> For the text of U.C.C. § 5-144(2)(a) & (b), see *supra* note 4. For a discussion of the separation of the letter of credit draft and acceptance from the underlying transactions (referred to in European and Latin American legal literature as "abstraction"), see Kozolchyk, *supra* note 17, at 113-14.

<sup>45</sup> It is believed that these credits were developed to accommodate certain foreign

a deferred payment credit looks like an irrevocable sight credit, except for a stipulation that payment will be made at a specified period after the beneficiary's presentation of the documents. The documents, meanwhile, are released by the issuing bank to its customer.

The bank that issues or confirms a deferred payment credit occasionally issues a statement to the beneficiary acknowledging that the documents received from the beneficiary complied with the terms and conditions of the credit. This statement is usually issued as a letter or memorandum and not as a negotiable instrument such as a draft or promissory note.<sup>46</sup> Frequently, however, the only acknowledgment issued by the issuing or confirming bank is simply a receipt for the tendered documents. The removal of the conditionality of a deferred payment credit by the issuance of an express statement of compliance or of a receipt of documents is not unlike the issuance of an acceptance in *Banco Bamerindus* and *Gotham*. Thus, the logic of these decisions may well transform deferred payment credits into "final payment" credits. Yet, as with the payment of sight drafts and of time drafts in the hands of the beneficiary or his collection agent, payment of a deferred payment credit is "not over until it is over." In fact, many European issuing banks warn the beneficiaries of their deferred payment credits that even if their advising banks issue commitments to pay at maturity, such commitments will not be recognized as binding by the issuing bank.

With this basic overview, it will be easier to follow the anal-

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exchange restrictions in effect in Japan in the early 1950's. For an early account of the use of these credits in European trade, see Bontoux, *Un Point D'histoire Bancaire. Le "Credit Documentaire Differe"*, 1956 REV. BANQUE 583-91. There is a growing amount of European literature on the subject of deferred payments. See, e.g., Blondeel, *Le Credit Documentaire a Paiement Differe*, 1964 REV. BANQUE 291; JOHANNES C.P. ZAHN, *ZÄHLUNG UND ZAHLUNGSSICHERUNG IM AUSHANDEL* 61, 152 (6th ed. 1986). On Latin American and especially South American practices, see Stoker, *PROBLEMÁTICA EN TORNO A LA UTILIZACIÓN DEL CRÉDITO DOCUMENTARIO EN LATINOAMÉRICA: FEDERACIÓN LATINOAMERICANA DE BANCOS, EL CRÉDITO DOCUMENTARIO EN AMÉRICA LATINA* 11-12 (Bogotá 1970) (arguing that deferred payment credits are frequently unacceptable to issuing banks, forcing the buyer to seek the intervention of banks from neighboring countries as issuers). For a helpful analysis of the problems posed by deferred payment credits and useful suggestions, see Gerald T. McLaughlin, *Should Deferred Payment Letters of Credit be Specifically Treated in a Revision of Article 5*, 56 BROOK. L. REV. 149 (1990).

<sup>46</sup> If the communication were to be issued as a negotiable instrument, such as a draft, it would unavoidably become an acceptance credit. In addition, as a negotiable instrument it would be subject to a stamp tax.

yses of the *Banco Bamerindus* decisions and to see where they went wrong.

## II. THE *BANCO BAMERINDUS* DECISIONS

### A. *Facts*

All Service Exportacao, Importacao Comercio, S.A. ("All Service") is a Brazilian company that entered into a contract to buy 15,000 metric tons of black beans for a price of approximately \$8 million dollars from M.M. International Ltd. ("MMI"), a Grand Cayman corporation owned by the People's Republic of China. The beans were to be shipped from China to Brazil. Payment was by means of an irrevocable negotiable letter of credit for the amount of the purchase in favor of MMI. The letter of credit was issued by Banco do Brazil ("Banco") in Brazil and was payable by means of a time draft at that bank's New York branch. It was advised but not confirmed by First Chicago International Bank ("First Chicago").

In June 1990 the beans were shipped from China. They arrived in Brazil in early October. According to the district court, "[i]t is not disputed that in late August, First Chicago presented to Banco's New York office MMI's draft, which Banco's New York branch marked 'Accepted.' Payment on the draft was to be made on October 29, 1990."<sup>47</sup> All Service successfully filed motions in Brazil and New York State courts to obtain temporary restraining orders ("TROs") against Banco and First Chicago, alleging defendants' fraud in the underlying transaction and in the presentation of documents. The TROs enjoined the defendants from paying the letter of credit. It is unclear which party held the draft when the TROs were filed in both New York and Brazil. It is also unclear whether Banco delivered the accepted draft or sent notification of the acceptance to the beneficiary before the issuance of the TROs. The defendants removed the case to the United States District Court for the Southern District of New York.

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<sup>47</sup> All Service Exportacao, Importacao Comercio S.A. v. Banco Bamerindus do Brazil, S.A., No. 90 Civ. 6797, 1990 WL 170343, at \*1 (S.D.N.Y. Oct. 31, 1990).

## B. *The District Court Opinion*

The district court held a hearing on All Service's motion for a preliminary injunction, allowing beneficiary MMI to intervene as of right.<sup>48</sup> All Service's request for a TRO and preliminary injunction relied on U.C.C. section 5-114(2)(a), which allows an injunction against a drawing tainted with fraud in the underlying transaction unless "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 that would make it a holder in due course . . . ."<sup>49</sup>

MMI, opposing the injunction, contended that U.C.C. section 4-303 prevailed over section 5-114. As noted earlier, section 4-303 provides that legal process served upon a payor bank seeking to terminate the bank's duty to pay an item "comes too late" if the legal process is received or served after the bank has "accepted or certified the item."<sup>50</sup> In so contending, MMI relied on the decision by the New York Court of Appeals in *First Commercial Bank v. Gotham Originals, Inc.*<sup>51</sup> In *Gotham* the New York court concluded that U.C.C. section 4-303 supersedes section 5-114. Accordingly, once the beneficiary's draft was accepted, the issuing-acceptor bank became unconditionally obligated to the holder to pay at maturity. A TRO that arrived after the date of the acceptance simply came "too late" to prevent payment to the beneficiary.<sup>52</sup>

All Service maintained that *Gotham*<sup>53</sup> and *Chemical*<sup>54</sup> were distinguishable because the banks demanding payment in those cases had negotiated the drafts and were holders in due course, while First Chicago was not such a holder. The district court labeled this argument "a distinction without legal significance"<sup>55</sup> since the petitioning bank in *Gotham* did not claim to be a holder in due course and the New York Court of Appeals ". . . explicitly declined to base its opinion upon the petitioning

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<sup>48</sup> *Id.* at \*3.

<sup>49</sup> N.Y.U.C.C. § 5-114 (McKinney 1991).

<sup>50</sup> See *supra* note 24 and accompanying text.

<sup>51</sup> 64 N.Y.2d 287, 475 N.E.2d 1255, 486 N.Y.S.2d 715 (1985).

<sup>52</sup> All Service Exportacao, Importacao Comercio S.A., 1990 WL 170343 (S.D.N.Y. Oct. 31, 1990).

<sup>53</sup> 64 N.Y.2d 287, 475 N.E.2d 1255, 486 N.Y.S.2d 715 (1985).

<sup>54</sup> 70 N.Y.2d 344, 514 N.E.2d 1358, 520 N.Y.S.2d 734 (1987).

<sup>55</sup> All Service Exportacao, Importacao Comercio S.A., 1990 WL 170343, at \*2.

bank's status as a holder in due course."<sup>56</sup>

Nor was *United Bank Ltd. v. Cambridge Sporting Goods Corp.*<sup>57</sup> applicable, according to the district court, because the draft in that case, unlike that in *Banco Bamerindus*, had not been accepted by the issuing bank before the injunction. The district court expressed sympathy with Banco's predicament: on the one hand, it remained subject to a Brazilian court's injunction ordering it not to pay the holder and, on the other hand, it was about to be made subject to a federal court decision ordering it to pay the same holder. Yet "having entered the New York letter of credit market of its own free will, Banco is bound by the prevailing law of that forum."<sup>58</sup> To avoid the impression of lack of hospitality to foreign, especially Brazilian, court decrees, the district court stated that its decision "does no violence to appropriate principles of comity between sovereign nations."<sup>59</sup> However, the court failed to offer any support for this assertion.

### C. *The Second Circuit Decision*

All Service appealed the district court's denial of its motion for a preliminary injunction. The Second Circuit affirmed the lower court's decision.<sup>60</sup> The Second Circuit provided more facts than the district court, but its version of which party held the draft during the applicable time period for section 4-303 was also incomplete. In its initial summary, the Second Circuit indicated that "the draft remained *in the hands of MMI*, an alleged defrauding seller . . . ."<sup>61</sup> Yet only three paragraphs later the Second Circuit added: "In August, at the request of First Chicago, Banco accepted the draft and *retained physical possession of it*."<sup>62</sup>

The determination of which party is the holder of the accepted draft is important because it helps establish the rights conveyed by the acceptance. If the holder of the acceptance

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<sup>56</sup> *Id.* (citing *First Commercial Bank v. Gotham Originals*, 64 N.Y.2d at 295, 495 N.E.2d at 1258, 486 N.Y.S.2d at 719).

<sup>57</sup> 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976).

<sup>58</sup> *All Service Exportacao, Importacao Comercio S.A.*, 1990 WL 170343, at \*3.

<sup>59</sup> *Id.*

<sup>60</sup> *All Service Exportacao, Importacao Comercio, S.A. v. Banco Bamerindus do Brazil S.A.*, 921 F.2d 32 (2d Cir. 1990).

<sup>61</sup> *Id.* at 33 (emphasis added).

<sup>62</sup> *Id.* at 34 (emphasis added).

qualifies as a holder in due course, he will enjoy superior rights to those of a mere holder or original payee.<sup>63</sup> In addition, an acceptance only becomes operative when it is delivered or notified to its lawful holder.

Section 3-410 of the U.C.C. defines an acceptance and its operativeness as follows: "Acceptance is the drawee's signed engagement to honor the draft as presented. It *must be written on the draft*, and may consist of his signature alone. It becomes operative *when completed by delivery or notification*."<sup>64</sup> In light of this provision, the Second Circuit's reference to the accepted draft remaining with the beneficiary is highly significant. If what the Second Circuit meant by "remained" is that the draft never left the beneficiary's possession, then no valid acceptance could have been created: how could the issuing bank write or stamp and sign its acceptance on a draft that was never in its possession? On the other hand, if the letter of credit called for the presentation of a draft and documents, how could the beneficiary have complied without presenting the draft? The apparent contradiction was explained by the Second Circuit in a subsequent statement:

Prior to the cargo's arrival in Brazil, MMI forwarded the necessary papers to First Chicago, the advising bank to MMI, together with a draft dated July 29, 1990, in the amount of \$8,250,000. The documents appeared on their face to comply with the conditions set forth in the letter of credit. In August, at the request of First Chicago, Banco accepted the draft and retained physical possession of it . . . . After shipment arrived in port, an independent agency determined the beans were soybeans, rather than black beans, and presented "a general mouldy or fermented aspect, improper for human consumption." On the basis of that report, All Service decided that a fraud in the transactions had occurred. Accordingly, it sought to prevent payment pursuant to the letter of credit by seeking an injunction in a Brazilian court. On October 19, that court issued the requested injunction. *One day later, MMI's agent recovered physical possession of the draft.*<sup>65</sup>

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<sup>63</sup> See U.C.C. § 3-305; see also BORIS KOZOLCHYK, *COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS* 454-83 (1966) [hereinafter *Commercial Letters of Credit*] (discussing "abstraction" or independence of the letter of credit promise).

<sup>64</sup> See U.C.C. § 3-410 (emphasis added). The 1990 Official Text of U.C.C. section 3-409 corresponds to the 1964 version of section 3-410. The 1990 Official Text of U.C.C. is slightly different but still requires that the acceptance "be written on the draft." See *SELECTED COMMERCIAL STATUTES* 385 (West 1991).

<sup>65</sup> *Banco Bamerindus*, 921 F.2d 32, 34 (2d Cir. 1990) (emphasis added).

Thus what the Second Circuit must have meant by the draft "remaining" in the beneficiary's possession was that the draft did not leave the beneficiary's possession, i.e., it was not negotiated to a third party or sent for payment to Banco *after* MMI's agent recovered physical possession from Banco on October 20, 1992. This fact, however, would have made it impossible for the accepted draft to be in Banco's hands and in the process of being paid when the draft became payable on October 29 for, in the Second Circuit's words, "the draft remained in the hands of MMI, an alleged defrauding seller."<sup>66</sup>

### III. ANALYSIS

#### A. *Legal and Factual Prerequisites for the Application of U.C.C. Articles 4 and 5*

The identity and status of the holder of the accepted draft helps determine the availability of a U.C.C. section 5-114 injunction. If the holder qualifies as a holder in due course, the injunction provided by section 5-114 is unavailable.<sup>67</sup> Yet section 5-114 is not the only rule the applicability of which is determined by the status of the holder of the draft. Even if one were to accept the proposition that article 4 applies to letter of credit payments, section 4-303 requires that there be an acceptance or certification of what article 4 refers to as an "item."<sup>68</sup> Acceptance is not defined in article 4 of the U.C.C. However, the Official Comment to section 4-303 indicates that its meaning is the same as in section 3-410.<sup>69</sup> As will be discussed shortly, section 4-303 does not specify when the acceptance or certification must be issued or executed in order to qualify for priority over the "four legals."<sup>70</sup>

##### 1. The Meaning of Item

The term "item" is defined by section 4-104 of the U.C.C. as "any instrument for the payment of money even though it is not

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<sup>66</sup> *Id.* at 33.

<sup>67</sup> See U.C.C. § 5-114(2)(a); see *supra* note 4.

<sup>68</sup> U.C.C. § 4-303; see *supra* note 24.

<sup>69</sup> See U.C.C. § 4-303 cmt. 2.

<sup>70</sup> See *supra* note 24.

negotiable but does not include money.”<sup>71</sup> The 1990 Official Version of the U.C.C. provides further detail on the meaning of item: “Item means an instrument or promise or order to pay money *handled by a bank for collection or payment.*”<sup>72</sup>

This latter definition highlights the organic connection between “item” and banking deposits and collections.<sup>73</sup> Indeed such a connection is inevitable given article 4’s mission to provide what Karl Llewellyn described as “the legal machinery for a clean-running *collection* procedure.”<sup>74</sup> Consistent with article 4’s mission, section 4-303 is located in part 3 of article 4 under the heading “Collection of Items: Payor Banks.” This part, then, contains the rules that govern acts or events that take place or could take place once *the item deposited for collection reaches the payor bank*. It should be noted that in the collection-payment progression of article 4, what was originally a section 3-104 instrument, such as a draft or check, becomes an article 4 item once it is deposited for collection with a depository bank and is forwarded by this bank directly or indirectly to the drawee-payor bank. Although items can be as varied and intangible as wire transfers or other electronically recorded, stored or transmitted messages for the payment of money,<sup>75</sup> the most common

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<sup>71</sup> U.C.C. § 4-104(g).

<sup>72</sup> *Id.* (emphasis added).

<sup>73</sup> See U.C.C. Official Comment 8 to section 4-104. It states:

Since bonds and other investment securities under Article 8 may be within the term “instrument” or “promise,” they are items and when handled by the banks for collection are subject to this Article . . . . The functional limitation on the meaning of this term [item] is the willingness of the banking system to handle the instrument, undertaking or instruction for collection or payment.

U.C.C. § 4-104 cmt. 8.

<sup>74</sup> Karl Llewellyn, Brief Introductory Statement Re Article 4, State of New York, *Law Revision Comm. Report, Hearings on the Uniform Commercial Code*, Vol. 1, 284 (1954) (emphasis added).

<sup>75</sup> See *Singer Prods. Co. v. First American Bank of New York (In re Singer Prods. Co.)*, 102 B.R. 912 (Bankr. S.D.N.Y. 1989). *Singer* involved a contest between banks claiming assets of a customer-Chapter 11 debtor in possession. The connection between the term item and the bank collection process is reiterated by the bankruptcy court in its reasoning:

It is unclear whether a “wire transfer is an “item” taken for collection under article 4 . . . . The district court for the Southern District of New York . . . equated an advance on a wire transfer as part of its collection process with that of an advance on a check taken for collection under Article 4 principles, finding a wire transfer to be the equivalent of an item for Article 4 purposes.

*Id.* at 929. For state statutory law definitions of the term item to include electronically recorded, stored or transmitted messages for the payment of money and part of the arti-



instrument to become an item is the check, invariably a "cash" in contrast with a "time" or credit-instrument.<sup>76</sup>

The importance of carefully applying the label "item" to the appropriate instrument stems from the peculiarity of the rules that govern the collection and payment of checks. As a result of these peculiarities, the same instrument can be subject to different rules as an article 4 "item" and as an article 5 "document." Since letters of credit are essentially documentary promises,<sup>77</sup> when the letter of credit does not require a document other than a draft or demand for payment (as is the case with "clean" credits),<sup>78</sup> or where the draft is to be drawn against the applicant,<sup>79</sup> the beneficiary's draft does double duty as an order of payment and as a letter of credit document.

The process of collection of MMI's draft described by the Second Circuit in *Banco Bamerindus* is an article 5, and not an article 4, item collection process. The beneficiary presented the documents to a branch of the issuing bank through an intermediary remitting bank. This bank determined whether to honor the draft or demand for payment after verifying the compliance of the documents with the terms and conditions of the letter of credit. No provisional settlements or clearings were waiting to be firmed up while the issuing or confirming bank verified documentary compliance. Since MMI's draft was not part of an article 4 process of collection and payment when the TRO was entered and since it remained in the beneficiary's hands after the TRO was granted, the question arises whether U.C.C. section 4-303 is even applicable to the instant case.

## 2. The Context of Section 4-303

The reference to the "four legals" coming "too late" in section 4-303(1) has an urgent, almost eleventh hour ring to it.<sup>80</sup>

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cle 4 bank deposit and collection process, see HENRY J. BAILEY & RICHARD B. HAGEDORN, BRADY ON BANK CHECKS: THE LAW OF BANK CHECKS S11-3 (1987 & Cum. Supp. 1992).

<sup>76</sup> BAILEY & HAGEDORN, *supra* note 75, at S11-1-11-2.

<sup>77</sup> See U.C.C. § 5-103(1)(b). It defines "document" as "any paper" and does not exclude drafts from such a categorization. *Id.*

<sup>78</sup> See *Task Force Report*, *supra* note 1, at 1557-58.

<sup>79</sup> See UCP art. (10)(b)(iv).

<sup>80</sup> In the words of the late Fairfax Leary: "The final solution, now the law in Pennsylvania, is that priority will be determined in effect by a rule that the first to reach the bookkeeper will be given priority. This 'race-to-the-bookkeeper' rule results from the

Clearly, if payment of an item was not imminent, there would be no reason to refer to the incoming knowledge, notice or stop-order as coming too late. It would be a strange latecomer, indeed, if the event it was about to miss—final payment—were to take place several days or, as is common with many bankers' acceptances, months later.<sup>81</sup> Moreover, if the debt related to the "four legals" were not due and payable, how could a setoff be exercised?<sup>82</sup>

### 3. Legislative History of Section 4-303

U.C.C. section 4-303 seems to have been drafted for items for which payment was *imminent* and not merely prospective. The Official Comments to its 1982 and 1990 versions confirm this interpretation: *While a payor bank is processing an item presented for payment*, "it may receive knowledge or a legal notice affecting the item . . . . Sub-section (a) states the rule for determining the relative priorities between these various legal events and the item."<sup>83</sup>

The late and lamented Professor Fairfax Leary, an article 4

provisions of § 4-303." Fairfax Leary, Jr., *Article 4: Bank Deposits and Collections Under the Uniform Commercial Code*, 15 U. Prrr. L. Rev. 565, 574 (1954); see *supra* notes 24-25.

<sup>81</sup> The 1982 and 1990 Official Comments to section 4-303 confirm the imminent finality of the act by the payor bank by placing its acceptance and certification at the same level as its payment of the item in cash.

Once a payor bank has accepted or certified an item or has paid the item in cash, the event has occurred that determines priorities between the item and the various legal events usually described as the "four legals".

U.C.C. § 4-303(b) cmt. 1.

<sup>82</sup> See *Board of Trade of San Francisco v. Swiss Credit Bank*, 728 F.2d 1241 (9th Cir. 1982). The Ninth Circuit held that the bank had the right to set off amounts *due* under an arbitration award against any sums it owed to beneficiary under the letter of credit. For a discussion on bank setoffs against creditors of their customers, see D.E. Murray, *Banks Versus Creditors of Their Customers: Set-Offs Against Customers' Accounts*, 82 COMM. L.J. 449 (1977); Boris Kozolchuk, *supra* note at 17, at 53-54: (discussing setoffs and letter of credit law). For an analysis of this issue Canadian and English law, see LAZAR SARNA, *LETTERS OF CREDIT* 166, 167 (2d ed. 1986). See *supra* notes 24 & 81.

<sup>83</sup> U.C.C. § 4-303 cmt. 1. Official Comment 1 to U.C.C. section 4-303 in relevant part provides:

The comments to Section 4-213 describe the process through which an item passes in the payor bank. Prior to this process or at any time while it is going on, the payor bank may receive knowledge or a legal notice affecting the item . . . . Each of these events affects the account of drawer and may eliminate or freeze all or part of whatever balance is available to pay the item.

U.C.C. § 4-303 cmt. 1 (1982).

draftsman, described a typical section 4-303 priority battle as one between an attachment execution served on a bank officer at 12:00 p.m. and a certification of a check by another bank officer at the same bank at 11:50 a.m.<sup>84</sup> The battle was between, on the one hand, the imminent payment of items by cash or by cash-like drafts, acceptances, certifications of checks, settlements and posting of credits or debits and, on the other hand, the "four legals". These two sets of acts or events had to be chronologically close enough to compete in what Leary referred to as the "race to the bookkeeper."<sup>85</sup>

Leary's description of the most common methods of payment associated with the collection of items in the late 1940s provides clues about the function of the acceptance and certification referred to in section 4-303.<sup>86</sup> One method was the immediate payment of cash for cash items (mostly checks) presented

<sup>84</sup> Leary, *supra* note 80, at 575-76.

<sup>85</sup> *Id.* at 574. See also Robert A. Riegert, *Stopping Payment and Refusing Payment on Bank Checks*, 93 COMM. L. J. 137, 155-56 (1988). Professor Riegert points to examples of competing claims at the time of final payment, such as an attempted setoff if the bank has already paid out the money in cash. Professor Riegert goes on to illustrate the inapplicability of U.C.C. section 4-303 to presentations of certified or cashiers' checks at a later time:

When, however, a bank receives notice that [the] check it has just certified was stolen, the notice is obviously too late to prevent the certification-but it is not too late to prevent payment to the thief at a later time; and Section 4-303 was not intended to require such payment. Any other interpretation would lead to absurd results. For example, if the bank were compelled to pay the thief by Section 4-303, the bank would still be liable to the true owner under Section 3-603(1)-despite the payment it was compelled by Section 4-303 to make to the thief.

*Id.* (emphasis added).

<sup>86</sup> J. Fairfax Leary & Michael A. Schmitt, *Some Bad News and Some Good News from Articles Three and Four*, 43 OHIO ST. L. J. 611 (1982). Professor Leary's recollection is that "the practical banker appeared to be somewhat more concerned with the manner in which the item is sent for collection rather than the nature of the item." He adds that:

In the late 1940's there were two distinct Federal Reserve Regulations involved: Regulation G covering non-cash items, and Regulation J covering cash items, as defined in those regulations. The regulations have now been combined in the present Regulation J but the terms cash and non-cash remain

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*Id.* at 630-31. Leary provides another clue on the immediacy of payment context and on the nature of the payment media:

Well, the next thing we tried to do was to find a cutoff point for priorities, and for the time when a bank changes from being a payor bank, in the check system, to being a bank that has something to remit or has made some payment.

*Id.* (emphasis added). See *supra* note 25.

for payment over the bank's counter. This method implemented the policy that called for the paying bank to "pay now and investigate at leisure"; it was not customarily used in the payments of bank collection items, which were paid by the payor bank's remittance of a *draft drawn on another bank* or by the payor bank's sending or delivering its own cashier's check.<sup>87</sup> Thus the acceptances and certifications of section 4-303(1)(a) are devices used by payor banks *to pay for collection items*. They should not be confused with the items they pay for, including such items as the accepted drafts of *Banco Bamerindus* or *Gotham*.<sup>88</sup>

Although the legislative history materials related to section 4-303 are minimal, the Report of the Subcommittee on Article 4 to the New York Clearing House Subcommittee on the Proposed Uniform Commercial Code ("New York Report") and the opinion of an article 4 draftsman are not inconsistent with the suggested interpretation.<sup>89</sup> After noting that the proposed text of section 4-303 covered a period "*before an item is finally paid [and] during which the item nevertheless has priority of payment over any notice, stop order, legal process or valid set off,*" the New York Report referred to some difficulties in the proposed text.<sup>90</sup> Among these, was:

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<sup>87</sup> For the present media of remittance of payment for items used by banks, see the text of U.C.C. section 4-211 at *supra* note 20. For a case involving the use of a cashiers' check in the payment of a letter of credit and an application of U.C.C. section 4-303 to the immediate payment context suggested as the appropriate one by this writer, see *Tranarg C.A. v. Banca Commerciale Italiana*, 90 Misc. 2d 829, 396 N.Y.S.2d 761 (Sup. Ct. N.Y. County 1977). At the time an initial TRO had been served on the defendant bank, the defendant corporation had made demand under the letter and the defendant bank had issued its own official check to the correspondent bank and debited plaintiff's account.

<sup>88</sup> BAILEY & HAGEDORN, *supra* note 75, at S15-13-14. Bailey and Hagedorn reproduce the text of California and Nevada's amendments to section 4-303. One of these amendments, added to the list of cut off acts or events as item (f) states:

The item has been deposited or received for deposit for credit in an account of a customer with the payor bank. "Bailey and Hagedorn, state that this amendment is a return to the rule rejected by the U.C.C. draftsmen that final payment of an 'on us' item takes place for all practical purposes when the item is deposited in the customer's account.

*Id.* at S15-14. Regardless of whether the amendment amounts to final payment for "all practical purposes," the role of acceptances and certifications paying for such "on us" items appears to have been diminished.

<sup>89</sup> See State of New York, *Law Revision Comm., Report, Hearings on the Uniform Commercial Code* Vol. 1, 297, 318 (1954) [hereinafter *New York Report*].

<sup>90</sup> *Id.* at 297 (emphasis added).

If the bank has settled for an item by separate remittance in the form of a draft, may it thereafter stop payment on that draft on the ground that it had not "finally paid" the *item for which the draft was given*? Would the bank not remain liable on its draft?<sup>91</sup>

Walter D. Malcolm, an article 4 draftsman, testified during the New York hearings on the adoption of article 4. He stated that typically a remittance draft paying for a collection item was mailed to the Federal Reserve Bank from which the collection item was received. This mailing entailed various possible moments of final payment. Assume the decision to draw and forward the draft was made by a rural New England Bank ("NEB") on a Monday. Then on Tuesday a draft was drawn on a Boston bank and was mailed to the Federal Reserve Bank of Boston ("FRB") for collection. The FRB received the draft on Wednesday and presented it to the clearing house where credit was given for the draft. From the standpoint of the "four legals", it was unclear when such a draft was actually paid. By Malcolm's account, courts in the United States could have applied at least seven different rules on when the item was paid: (1) the moment that NEB made the decision to execute the remittance and forward it to FRB; (2) the moment the bookkeeper at NEB determined that there were enough funds to pay; (3) the moment the process of posting at NEB was completed; (4) the moment that NEB could no longer withdraw the remittance from the mails; (5) the moment the draft was received by the FRB; (6) the moment the draft was honored at the clearing house; and (7) in the case of insolvency of the payor bank, the moment when the presenting bank made the election on payment or non-payment of the item.<sup>92</sup> Malcolm asserted that the rule, which became section 4-303, reflected a policy determination such that

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<sup>91</sup> *Id.* at 298 (emphasis added). See also Letter from Robert H. Brome to Walter D. Malcolm, one of Article 4's draftsmen in *New York Report*, *supra* note 89, at 343-44. In the letter Brome pointed out that the customary manner of finally paying for non-cash items was not to grant provisional credits (as was done with cash items) but by separate remittance. It was not clear in the proposed draft whether these remittances could be considered as final payments and, if not, whether they needed to be posted as required for final payment. While Brome added that a properly informed court would consider these remittances as final payments (reasoning that they constituted agreements in variation of code requirements) since such remittances were quite common, confusion should be dispelled by the U.C.C.

<sup>92</sup> *Id.* at 472.

automatically when payment has been completed by the payor bank, a debtor-creditor relationship arises . . . the payor bank from that moment forward is indebted to the owner of the item for the amount of the item. It will remit or it will account for that indebtedness through the chain of banks, but basically, *having charged the account of the drawer from that moment forward it is indebted . . .*<sup>93</sup>

Paton's Digest was one of the most influential sources of pre-article 4 bank collections law.<sup>94</sup> Its description of the priority dispute between a stop payment order and a payment of a collection item through a remittance draft framed the issue consistently with the above interpretation. Typically the priority problem arose when the drawee bank received from the collecting bank, through the mail, a check drawn by one of the drawee bank's customers. The drawee bank marked the check paid, charged the drawer's account and *issued its draft in payment to the collecting bank*. According to Paton's Digest, the manner in which the drawee bank handled the check amounted to "an acceptance or payment of the check and constituted a full consummation of the transaction initiated by the drawing of the check . . ."<sup>95</sup>

In sum, the text, Official Comment and scant legislative history of section 4-303 indicate that acceptance under section 4-303(1)(a) is a means of immediate or imminent payment used by the payor bank in the article 4 collection chain to pay for collec-

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<sup>93</sup> *Id.* at 473 (testimony of Mr. Walter D. Malcolm) (emphasis added). The dispute between drafters was not on whether U.C.C. sections 4-303 or 4-213, (its companion section on final payment) should include cash-like means of payments given in payment of collection items, such as cashiers' and certified checks and accepted drafts, but on whether section 4-303 should adopt, among others, section 7 of the American Bankers Association ("ABA") Code of Collections. This section, provided that "where an item is received by mail by a solvent payor, it shall be deemed paid when the amount is finally charged to the account of the maker or drawer." *Id.* According to Malcolm, the article 4 draftsmen did not see the reason for limiting the scope of sections 4-213 and 4-303 to items received by mail by a solvent payor. In addition, they found other related provisions in the ABA Collection Code to be too narrow and imprecise, especially those that relied on the collecting bank's request or acceptance of an "irrevocable credit" for the item. *Id.* at 475-76, quoting § 11, and referring to §§ 2, 9, 10, 13(2) & (3) of the ABA Collection Code. The notion of final payment turned, according to Malcolm, on the collecting bank's request or acceptance of an unconditional credit. *But c.f. Id.* at 493-95 (Mr. Brome's reply).

<sup>94</sup> THOMAS B. PATON, 3 PATON'S DIGEST OF LEGAL OPINIONS 1341 (Am. Bankers Assoc., ed. 1940).

<sup>95</sup> PATON, *supra* note 94, at 1341, quoting *First National Bank of Portage v. Wisconsin National Bank of Watertown* 246 N.W. 593, 594 (Wis. 1933).

tion items in that bank's possession. The acceptance referred to in section 4-303(1)(a), however, is not the acceptance of the type in *Banco Bamerindus*. The *Banco Bamerindus* acceptance was not issued by Banco in payment of MMI's accepted time draft or of any other article 4 item. Unlike a means of immediate payment, MMI's accepted time draft was executed in mid-August 1990 and was payable in late October 1990. In addition, neither at the time of the injunction nor thereafter was MMI's accepted time draft submitted for payment to Banco either directly by MMI or by a collecting bank.

If All Service had not sought an injunction, several collection alternatives were available to MMI on October 20, 1990. First, MMI could have negotiated the accepted draft to a bank willing to give value for it and this negotiating bank or a subsequent one would have, at maturity, presented the acceptance for payment to the acceptor bank. Second, MMI could have discounted the draft with the accepting bank itself and this bank could have retained the acceptance until maturity or it could have renegotiated it. Third, MMI could have awaited the acceptance's due date and presented it for payment directly to the acceptor in New York or to its principal in Brazil. Fourth, it could have left the acceptance in the hands of the accepting bank until October 29, 1992. Finally, shortly before October 29, MMI could have deposited the acceptance for collection with a collecting bank and asked that it be forwarded for collection to the issuing bank. Some of these alternatives, especially the last one, could have become subject to section 4-303. At the time of the disputed injunction, however, MMI had not chosen any collection procedure that could have brought section 4-303 into play.

B. *New York Decisional Law: First Commercial Bank v. Gotham Originals*

1. Facts

The New York Court of Appeals in *Gotham* was faced with a situation that was, in many respects, similar to that in *Banco Bamerindus*.<sup>96</sup> *Gotham Originals*, a New York importer, purchased shoes from Taiwanese manufacturers and obtained an irrevocable letter of credit from Bank Leumi in New York to pay

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<sup>96</sup> 64 N.Y.2d 287, 475 N.E.2d 1255, 1256-1258, 486 N.Y.S. 2d 715 (1985).

for the shoes. This letter of credit designated Teng Shih Industries as beneficiary and First Commercial Bank of the Republic of China ("First Commercial") as the advising bank. The transferable letter of credit for approximately \$172,000 was transferred to an R. Bore International Inc. ("R. Bore"). The amount of the transfer is not specified in the opinion, but one may infer from the fact that R. Bore presented two drafts for \$71,000 to First Commercial that the transfer to R. Bore was at least for that sum. First Commercial received R. Bore's two drafts for \$71,000 on September 10, 1981—five days after the credit expired. First Commercial detected this late presentation discrepancy, but credited R. Bore's account with the amount of the letter of credit, subject to the reservation that the issuing bank and the applicant waive the discrepancy. Bank Leumi obtained the applicant's waiver and on September 24, 1981 notified First Commercial by letter that the drafts had been accepted and would be paid on November 23, 1981. Before the time of payment, the applicant discovered that the merchandise was worthless, brought an action in New York County's supreme court against the sellers and sought a TRO against Bank Leumi's transfer of the letter of credit proceeds or any "moneys or assets of the sellers."<sup>97</sup> Gotham Originals also sought orders attaching the proceeds of R. Bore's drafts.

The applicant was granted the TRO by the New York court. A special proceeding followed to determine adverse claims to funds and assets held by the issuer of the letter of credit.<sup>98</sup> One adverse claimant was the applicant who had obtained the TRO. The other was the advising bank. It alleged that it had paid or negotiated the letter of credit draft. The advising bank petitioned to vacate the restraining and attachment orders and to obtain a determination that U.C.C. section 4-303 controlled the transaction, thereby requiring the issuing bank to pay. Following a special term decision favorable to the applicant, the appellate division held that section 4-303 applied and the attachment and injunction were untimely; thus the issuing bank was obligated to pay. This decision was appealed to the New York Court of Appeals.<sup>99</sup>

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<sup>97</sup> *Id.* at 293, 475 N.E.2d at 1258, 486 N.Y.S.2d at 718.

<sup>98</sup> *Id.*; *Banco Bamerindus*, 921 F.2d 32 (2d Cir. 1990).

<sup>99</sup> 64 N.Y.2d at 293, 475 N.E.2d at 1258, 486 N.Y.S.2d at 718.



Considerable ambiguity exists about the court of appeals' characterization of the advising bank's function as a negotiator and on the nature of the issuing bank's acceptance in *Gotham*. As in *Banco Bamerindus*, the characterization of the holder and payee of the draft is critical for the application of sections 4-303 and 5-114. Hence, it is necessary to transcribe and evaluate the court of appeals' characterizations:

Transferee-beneficiary . . . negotiated to petitioner two drafts . . . payable on sight 60 days from date . . . . Petitioner paid for the drafts in Taiwanese currency and credited the amounts to R. Bore's checking account although it did so "under reserve" because the letter of credit had expired on September 5, 1981. On September 21st, Bank Leumi received from petitioner the two drafts, the required documentation and transmittal letters and a request for payment of the drafts on Gotham's letter of credit. Petitioner disclosed the discrepancy of the expiration date, noted that it had *negotiated under reserve* and requested advice as to when it could lift the reserve and make *final payment to R. Bore*. Bank Leumi subsequently obtained a waiver of the discrepancy . . . and on September 24th it notified petitioner by letter that the drafts had been accepted and that payment would be made on November 23, 1981. After Bank Leumi had accepted the drafts *but before it paid them*, Gotham instituted an action against Teng Shih, R. Bore and the other seller manufacturers in the Supreme Court, New York County claiming that they had sold it worthless merchandise and charging them with fraud . . . .<sup>100</sup>

## 2. The *Ratio Decidendi* of *Gotham*

### a. *The Status of First Commercial as a Negotiating Bank*

The transcribed text first refers to petitioner-advising bank as a negotiating bank.<sup>101</sup> Immediately after, however, it refers to First Commercial as a bank that paid for the drafts.<sup>102</sup> Subsequent characterizations in the same paragraph add to the confusion. At one point it appears that the payment made by First Commercial when the drafts were presented to it was only provisional because First Commercial is said to have requested authority from Bank Leumi to make a final payment.<sup>103</sup> Yet later it appears that Bank Leumi itself was going to pay for the drafts

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<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

and not merely reimburse First Commercial for its payment.<sup>104</sup> As if First Commercial's status as a holder of the drafts was not sufficiently confused, the court of appeals added the following characterization:

By purchasing signed drafts drawn under the letter of credit by the transferee-beneficiary, and because of respondent issuing bank's express engagement in the letter of credit to honor drafts presented by a negotiating bank, petitioner acquired rights against respondent bank, as issuer, *to the same extent as if it were named as beneficiary of the credit.*<sup>105</sup>

The New York Court of Appeals' characterization of First Commercial as both a bank that "*paid* for the drafts" and as "a negotiating bank . . . purchasing signed drafts" is contradictory.<sup>106</sup> While advising banks often act as paying banks in such cases, as was discussed earlier, the UCP sanctioned banking practice is to *nominate*, *i.e.*, expressly designate the advising bank as a paying bank,<sup>107</sup> and to leave the determination of document compliance to the nominating, issuing or confirming bank. When the advising bank acts as a paying bank and pays, there is no need for negotiation. Payment extinguishes the issuing and confirming banks' liability and leaves nothing to be negotiated. Since the court of appeals' statement of facts does not refer to a payment nomination, instead referring to a clause in the letter of credit enabling the advising bank's negotiation, one must assume that First Commercial was not acting as a paying bank when it credited R. Bore's account.

Negotiation, on the other hand, means different things in letter of credit practice. Some banks not nominated to confirm, negotiate or pay, refer to their examination of documents as a negotiation whether such an examination was volunteered by them or requested by the beneficiary. Other banks term their examination of the documents, endorsement of beneficiary's draft and delivery of the documents to the issuing or confirming bank as a negotiation. These two purported negotiators act merely as conduits for the presentation of documents to the issuing, confirming or paying banks neither give value for the

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<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 296, 475 N.E.2d at 1260, 486 N.Y.S.2d at 720 (emphasis added).

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

draft nor promise to do so. Most of the banks in international letter of credit transactions use the term "negotiation" to signify the purchase of documents from the beneficiary or from a bank remitting the documents on the beneficiary's behalf. This negotiation must be authorized in the credit.<sup>108</sup> Depending upon whether the negotiating bank is also a confirming bank and also upon the place or market where the draft and documents are purchased, the business relationship between a beneficiary and a negotiating bank and the stage of the transaction, the purchase may be with or without recourse to the beneficiary.<sup>109</sup> When a purchase is made without recourse, the negotiating bank assumes the risk of rejection of the documents by the issuing or confirming bank for not being in compliance with the terms of the credit. In another, less common, version of negotiation, banks examine the documents, notify the issuing or confirming bank that the documents comply with the terms of the credit and agree with the beneficiary that if the issuing or confirming bank does not honor the credit, they will.<sup>110</sup>

It is not clear where First Commercial fits in the preceding categories. It would be foolhardy to purchase or give value for documents that contain a discrepancy as serious as a presentation beyond the expiration of the credit; the documents for which value was given could, very possibly, be worthless. Moreover, it is highly doubtful whether a bank, aware of such an infirmity when purchasing the draft, could qualify as a holder in due course of beneficiary's draft. Conversely, if all First Commercial did was to provide R. Bore with a provisional credit subject to reversal of this credit when the applicant refused to waive

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<sup>108</sup> UCP art. 10(a)(iv).

<sup>109</sup> See, e.g., UCP art. 10(b)(iv) (where the confirming bank is said to "negotiate without recourse to drawers and/or bona fide holders, drafts . . ."). Nowadays, true negotiation is not readily available. Outside of the United States, some financial centers in the Orient, such as Singapore, are known as negotiation centers. The relationship between the beneficiary and the negotiating bank is also a major factor in the manner and frequency of negotiation. Finally, an accepted draft by a bank of known solvency is much more easily negotiable than an unaccepted draft.

<sup>110</sup> To eliminate the ambiguity of such varied meanings the proposed revision of the UCP defines negotiation as giving value for the documents. Presumably a promise to honor if the issuing or confirming bank do not, is the equivalent of giving value. See Chamber of Commerce, Document No. 470-37/72, 5/5/1992. Article 10(b)(ii) provides that: "Negotiation means the giving of value for the Draft(s) and /or documents(s) by the negotiating bank. Mere examination of the documents without giving of value does not constitute a negotiation." *Id.*

the discrepancy, it would be acting essentially as a collecting bank and not as a true negotiating bank.

If First Commercial became a negotiating bank "by purchasing signed drafts drawn under the letter of credit by the transferee-beneficiary,"<sup>111</sup> then the court of appeals would have been justified in granting payment to First Commercial as a holder in due course under section 5-114 of the U.C.C., regardless of the beneficiary's fraud. Had this been the basis for the court of appeals' decision, letter of credit law would have remained undisturbed and *Banco Bamerindus* could well have found that an injunction is available against a fraudulent beneficiary. The court of appeals, however, also concluded that First Commercial "acquired rights against the respondent bank, as issuer, to the same extent as if it were named as beneficiary of the credit."<sup>112</sup> In letter of credit and negotiable instruments law, the rights of a negotiating bank purchasing a draft are independent of a beneficiary's rights.<sup>113</sup> If such a negotiating bank only acquired rights "to the same extent as if it were named as beneficiary of the credit," it would be subject to personal and real defenses by the issuing bank against the beneficiary. Accordingly, if, for example, a credit was amended with a beneficiary's consent and the amendment did not appear on the operative credit instrument shown to the negotiating bank, a beneficiary's failure to comply with the amendment could be raised by the issuing bank as a defense against the negotiating bank even though this bank was ignorant of the amendment. In addition, the negotiating bank would be subject to the same setoff as a beneficiary that owes money to the issuing or confirming bank and, *a fortiori*, to real defenses such as fraud.<sup>114</sup> As discussed in Part I, the beneficiary's vulnerability to the issuing or confirming bank's personal and real defenses significantly affects the determination of the moment of final payment to him. For if the beneficiary is subject to defenses, such as amendment or novation of the credit, setoff, or fraud that comes about or is discovered after the presentation of documents and acceptance of the draft, final payment cannot be said to have taken place at the

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<sup>111</sup> *Gotham*, 64 N.Y.2d at 296, 475 N.E.2d at 1260, 486 N.Y.S.2d at 720 (1985).

<sup>112</sup> *Id.* (emphasis added).

<sup>113</sup> See Kozolchuk, *supra* note 63 and accompanying text.

<sup>114</sup> *Id.*

time the draft was accepted. Indeed, Professor John Dolan reads some decisions as suggesting that the "issuer's act of accepting time drafts does not discharge its liability on the credit."<sup>115</sup> No true negotiating bank, then, would want to have rights "to the same extent as if it were named as beneficiary of the credit."<sup>116</sup> What is even more confusing is that the *Gotham* court seemed aware of this distinction. In the paragraph preceding the questionable characterization, it stated:

Thus, if petitioner had taken the drafts under circumstances which made it a holder in due course, it would have acquired greater rights than the beneficiary and Bank Leumi would be obligated to honor the drafts despite Gotham's allegations of fraud in the transaction.<sup>117</sup>

In conclusion, it is not clear from the court of appeals' characterization whether "final payment" was made by First Commercial on R. Bore's two drafts when First Commercial, acting as a paying bank, provisionally or finally credited R. Bore's account, or whether final payment on the drafts was about to be made by Bank Leumi when the accepted drafts were going to be presented for payment by First Commercial. If final payment took place at First Commercial books or counters, then the injunction against Bank Leumi was misdirected and was, in any event, too late. If First Commercial was not a paying bank and was a mere collecting bank for R. Bore as transferee of the credit, final payment, from an article 5 and UCP standpoint, could not have taken place until Bank Leumi paid the acceptance to R. Bore. Until the moment of presentation of the accepted drafts for final payment by the transferee or its agent for collection, the issuing bank could have raised all its personal and real defenses against R. Bore. Thus where the *Gotham* beneficiary, transferee or its agent for collection are concerned, payment cannot be final when the acceptance of Bank Leumi was issued.

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<sup>115</sup> JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT* ¶ 2.09 n.143 (1984).

<sup>116</sup> *Gotham*, 64 N.Y.2d at 296, 475 N.E.2d at 1260, 486 N.Y.S.2d at 720.

<sup>117</sup> *Id.* at 295, 475 N.E.2d at 1259, 486 N.Y.S.2d at 719.

- b. The *Gotham* Court Ambiguity: Did Bank Leumi Issue an Acceptance? If So, Which Party Was Its Holder?

The New York Court of Appeals did not indicate whether Bank Leumi's acceptance of R. Bore's time drafts was inserted on the drafts or whether the accepted drafts were delivered to the beneficiary or to the transferee of the credit. All the opinion says is that Bank Leumi notified First Commercial by letter that the drafts had been accepted and that payment would be made sixty days or so later. If the original beneficiary had retained the right to draw for a percentage of the credit, Bank Leumi would have violated the terms of the credit if it accepted transferee's drafts for the face amount of the credit. Such an acceptance could have forced Bank Leumi to pay the same amount twice: first, to the transferee, holder of the acceptance for the full amount of the credit, and second, to the original beneficiary for his share of the credit. For the same reason, Bank Leumi would have been ill- advised to deliver an acceptance for the full amount of the credit to the original beneficiary. In fact, the original beneficiary should not have been given an acceptance even for his share of the credit if his right to draw depended upon the transferee's compliance with the credit, especially if the transfer in question was one with "substitution of invoices."<sup>118</sup>

Likewise, the *Gotham* court did not indicate whether the original beneficiary had retained the right to draw and, if so, for what percentage of the credit. If an original beneficiary retains a right to draw for part of the credit amount and the credit, as in this case, authorizes free negotiation, many issuing banks nominate themselves or another bank as the only banks empowered to affect the transfer. As the exclusive transferring banks, they retain the transferee's accepted draft until they receive all the necessary documents to honor the credit, including the original beneficiary's draft(s). This may explain why the *Gotham* court did not indicate that Bank Leumi mailed the acceptance to R. Bore. Yet as discussed in connection with *Banco Bamerindus*, if the accepted draft was not delivered to its payee (the original beneficiary or the transferees) or if the payee was not notified of the acceptance, U.C.C. section 3-410 makes it clear that no operative acceptance existed.

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<sup>118</sup> See UCP art. 54(e) & (f).

Moreover, if the court of appeals regarded as an acceptance the letter sent by Bank Leumi to First Commercial indicating that the drafts were accepted, it acted contrary to the express language of U.C.C. section 3-410. According to this provision, an acceptance "must be written on the draft."<sup>119</sup> As made clear by the U.C.C. Official Comment, the "virtual" or "collateral acceptances" of sections 134 and 135 of the Negotiable Instruments Law that preceded the U.C.C. are no longer enforceable.<sup>120</sup> Consequently, Bank Leumi's letter to First Commercial is not an acceptance under U.C.C. sections 3-410 and 4-303. In the absence of proof that a valid acceptance existed, and that it was executed on an article 4 item, the *Gotham* letter of credit simply is outside the scope of section 4-303.<sup>121</sup>

### 3. "Fixing" the Moment of Final Payment of a Transferable Credit

To apply U.C.C. section 4-303, the *Gotham* court had to establish when the final decision to pay R. Bore's drafts was made. After referring to the principle that letters of credit are independent from underlying transaction equities and that banks are only concerned with documents and not with goods,<sup>122</sup> the court of appeals proffered its own rule of finality of letter of credit payments: "Thus, the issuer's obligation to pay is *fixed* upon

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<sup>119</sup> 1982 U.C.C. § 3-410 cmt. 3. It made clear that this subsection adopted section 17 of the English Bills of Exchange Act which provides that the acceptance must be written on the draft. It also adds that this sub-section

eliminates the original sections 134 and 135 providing for "virtual" acceptance by a written promise to accept drafts to be drawn, and "collateral" acceptance by a separate writing. Both have been anomalous exceptions to the policy that no person is liable on an instrument unless his signature appears on it. Both are derived from a line of early American cases decided at a time when difficulties of communication, particularly overseas, might leave the holder in doubt for a long period whether the draft was accepted. Such conditions have long ceased to exist and the "virtual" or "collateral" acceptance is now almost entirely obsolete. Good commercial and banking practice does not sanction acceptance by any separate writing because of the dangers and uncertainties arising when it becomes separated from the draft. The instrument is now forwarded to the drawee for his acceptance upon it, or reliance is placed upon the obligation of the separate writing itself, as in the case of the letter of credit.

1982 U.C.C. § 3-410 cmt. 3.

<sup>120</sup> *Id.*

<sup>121</sup> See *supra* note 25 and accompanying text.

<sup>122</sup> *Gotham*, 64 N.Y.2d at 294, 475 N.E.2d 1259, 486 N.Y.S.2d at 718.

*presentation* of the drafts and the documents specified in the credit . . . ."<sup>123</sup> This rule ascribes serious legal consequences to the concept of fixation of the obligation to pay, despite that concept's uncertain meaning in letter of credit law and practice. Neither bankers nor banking lawyers can confidently respond to the question of what a bank has to do to "fix" its obligation to pay a letter of credit. Does fixing an obligation to pay mean the same thing as establishing the irrevocability of an issuance under U.C.C. section 5-106?<sup>124</sup> It would not seem so because the U.C.C. establishment takes place during the phase of issuance of the letter credit, while the fixing of the payment obligation seems to take place after a beneficiary's compliance and during the phase of payment.

Does fixing the obligation to pay, then, mean determining the facial compliance of the documents with the terms and conditions of the credit, thereby rendering the bank's promise unconditional? This could be the meaning of "fixing," but if such were its meaning, "to fix an obligation to pay" would fall considerably short of final payment. As indicated earlier, the unconditionality of the bank's promise does not preclude the bank from retaining its personal as well as real defenses against the beneficiary holder of the draft.<sup>125</sup>

If the court of appeals was attempting to pave the way for the application of U.C.C. section 4-303,<sup>126</sup> one may surmise that "to fix an obligation to pay" refers to the moment when the final decision to pay the credit is made. Yet if this is the meaning of the court's rule, then it finds no support from the letter of credit principle of independence. The principle of independence or abstraction is not a "rule of traffic"—it does not govern the time when a credit is deemed established or finally paid. It is a rule intended to guide the proper drafting and interpretation of letter of credit terms and conditions and to establish the unavailability of defenses related to underlying transactions.<sup>127</sup> Thus it does not follow from a directive on how to draw up a credit or how to examine documents that the obligation to pay is finally

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<sup>123</sup> *Id.* (emphasis added).

<sup>124</sup> N.Y.U.C.C. § 5-106 (McKinney 1991).

<sup>125</sup> See *supra* text accompanying notes 41-42.

<sup>126</sup> See *supra* note 25 and accompanying text.

<sup>127</sup> Kozolchyk, *supra* note 17, at 113-14.



fixed upon at any given time, even if the time is that of presentation of conforming documents. Aside from the lack of connection between independence and final payment, the decision to make final payment may have to be made at a time after the presentation of documents or it may not have to be made at all, despite the presentation of documents. As discussed earlier, following the presentation of documents a credit may be amended with beneficiary's consent, or the bank may successfully raise the defense of fraud against the beneficiary. Finally, the court of appeals' fixation of final payment at the time of presentation of complying documents is particularly unsuited for transferable credits because these credits often entail different presentations by different parties. Presentation of documents by a transferee is often only the first step in "fixing" the issuing or confirming bank's obligation of payment. If the credit provided for a transfer in which the original beneficiary retained the right to substitute his invoices for those of the transferee, the original beneficiary would still have to substitute his own invoice and possibly other documents before the issuing bank could begin to examine the documents required by the credit, let alone make the final decision to pay it. If the credit did not provide for the right to substitute invoices and the original beneficiary retained the right to draw for the beneficiary's share of the credit, his right to draw would not be "fixed" until he submitted his invoice and whatever additional documentation was required to the transferring bank.

The New York Court of Appeals did not seem to grasp the distinction between transferable credits and credits where drafts are freely negotiable. According to the *Gotham* court, "[b]y issuing a letter of credit, the issuer undertakes an obligation to pay the beneficiary, or his *transferee* if the letter of credit is *negotiable*, from the account of the customer."<sup>128</sup> Strictly speaking, there is no such thing as a "negotiable" credit.<sup>129</sup> Therefore, contrary to the court of appeals' statement, a transferee cannot demand honor merely because the letter of credit is "negotiable," i.e., it contains a clause enabling payment to a *bona fide* holder of a beneficiary's draft(s). The court of appeals' confusion may

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<sup>128</sup> *Gotham*, 64 N.Y.2d at 294, 475 N.E.2d at 1258, 486 N.Y.S.2d at 718 (emphasis added).

<sup>129</sup> KOZOLCHYK, *supra* note 63, at 519-54.

account for its unwarranted equation between the decision to make final payment on the credit and the transfer of the credit.

The transfer of the credit takes place at an earlier time than the decision to make final payment on the transferable credit. A decision to make final payment on a transferable credit presupposes that the following transfer-related steps were completed: (1) notification by the issuing bank to the transferring bank (if this is a bank other than the issuing bank) of the issuance of a transferable credit to be transferred by the transferring bank(s); (2) request by the beneficiary for a transfer; (3) notification to the beneficiary by the transferring bank that a transferable credit has been issued in its favor for a certain amount or percentage of the face amount of the original credit upon specified terms and conditions; (4) notification of the transfer by the transferring bank to each transferee; (5) presentation by the transferee to the transferring bank of complying documents; (6) verification by the transferring bank of the transferee's documentary compliance; (7) substitution of invoices and/or presentation of complying documents by the original beneficiary and remaining transferees; and (8) decision by the transferring bank to make final payment on the transferable portions of the credit. Since R. Bore had, presumably, been notified of the transfer by First Commercial acting, apparently, as a transferring bank, steps 7 and 8 had not been completed when the TRO was issued. If, however, the TRO also included the transfers to other shoe manufacturers-transferees that had not yet presented their documents, then steps 2 through 8 may well have had to be completed before final payment could be made to those transferees and the original beneficiary. Accordingly, if what the TRO sought to prevent was the transfer (as contrasted with the final payment) of the credit, it had to arrive at an earlier time than the time when the decision to pay the credit was "fixed."

#### 4. The Logic in Support of the Application of Article 4

##### a. *A Faulty Syllogism*

The key issue raised by the parties in *Gotham* was which U.C.C. article to apply, article 5 on letters of credit or article 4 on bank deposits and collections. Petitioner First Commercial based its claim of untimeliness of the injunction on U.C.C. section 4-303(1)(a), while respondent Gotham Originals contended

that the TRO was timely under section 5-114(2)(b) because the order was served upon the bank before it honored the drafts. The court of appeals acknowledged that the U.C.C.'s definition of honor is "to pay or to accept and pay"<sup>130</sup> and that under this definition and section 5-114(2) the TRO was timely. However, the court of appeals agreed with the appellate division and found the order untimely under U.C.C. section 4-303 because Bank Leumi had accepted the drafts before the arrival of the TRO.

The court of appeals provided various reasons to apply article 4. First, it justified its reliance on article 4 because the issuer of the letter of credit was a bank. The court set forth its reasoning in a footnote:

Article 4 of the Uniform Commercial Code governs bank deposits and collections and applies to this case because the issuer of the letter of credit was a bank. Letters of credit may be issued by parties other than banks, however, and Article 4 of the Uniform Commercial Code and part III of this opinion would not apply to such persons.<sup>131</sup>

This justification rests on a faulty syllogism. The court of appeals' major premise is that article 4 governs "bank deposits and collections" and thus concludes that article 4 applies because the issuer of the letter of credit is a bank. Yet, what happened to "deposits and collections" and to the other antecedents of the court of appeals' major premise? Unless a transaction encompasses a deposit or a collection and the banks involved are part of the collection and payment stream, the mere fact that the issuer of the promise is a bank does not subject the transaction in question to article 4. After all, banks issue promises of payment or extend credits in connection with each and every U.C.C. article transaction. Clearly, not all these U.C.C. articles are displaced when a bank issues the promise of payment. At best, then, the presence of an issuing bank could be a necessary, but not sufficient, condition to apply article 4.

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<sup>130</sup> See U.C.C. § 1-201(21).

<sup>131</sup> *Gotham*, 64 N.Y.2d 287, 292 n.3, 475 N.E.2d 1255, 1257 n.3, 486 N.Y.S.2d 715, 717 n.3.

b. *The Search for a Necessary and Sufficient Condition for the Application of Article 4*

To be persuasive, the court of appeals had to demonstrate that the U.C.C. or related law provided the necessary and sufficient basis to apply article 4. It attempted to do so as follows:

Section 4-102 of the Code provides that if the provisions of article 4 conflict with those of article 3 then article 3 shall govern . . . . It contains no similar provision with respect to a conflict with the provisions of article 5 nor does any section of article 5 deal with the conflict. The controlling language *must be found* in section 4-303 (1) . . . It states that any legal process served upon a payor bank "*whether or not effective under other rules of law*" to terminate or suspend the bank's duty to pay the item comes too late . . . if the bank has previously accepted the item . . . . section 5-114 contains no similar provision. Indeed, the Legislature made clear that article 5 and the UCP do not control every aspect of the transaction that involves a letter of credit when it provided that article 5 was intended to deal with some but not all of the rules and concepts of letters of credit . . . Accordingly, section 4-303 by its terms, supersedes section 5-114 . . . .<sup>132</sup>

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<sup>132</sup> 64 N.Y.2d at 295, 475 N.E.2d at 1260, 486 N.Y.S.2d at 720 (emphasis in original). At this point the court of appeals cited U.C.C. sections 3-413 and 3-410(1) on acceptances and *United States Rail Co. v. Wiener*, 169 A. D. 561, 155 N.Y.S. 425 (1915). The text of section 3-410(1) as interpreted by the Court of Appeals (before the 1990 revision) is as follows: "Acceptance is the drawee's signed engagement to honor the draft as presented. *It must be written on the draft*, and may consist of his signature alone. It becomes operative when completed by delivery or notification." N.Y.U.C.C. § 3-410(1) (emphasis added).

The first three subsections of section 3-409 of the Official Uniform Commercial Code of 1990 correspond to former section 3-410. The relevant language presently in force is found in the 1990 version of section 3-409(a):

Acceptance means the drawee's signed agreement to pay a draft as presented. *It must be written on the draft*, and may consist of the drawee's signature alone. Acceptance may be made at any time and becomes effective when notification pursuant to instructions is given or the accepted draft is delivered for the purpose of giving rights on the acceptance to any person.

N.Y.U.C.C. § 3-409(a) (McKinney 1991) (emphasis added). As is readily apparent from these two texts, the essential requirement of insertion or incorporation of the acceptance on the draft remains in force. Section 3-413 underwent a more substantial revision, although the principle of primary liability (as contrasted with the secondary liability of the drawer of the draft) remained the same. The text in force at the time of Judge Simon's decision stated: "The maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement . . . ." N.Y.U.C.C. § 3-413(1) (McKinney 1982). The 1990 version of section 3-413(a) states in relevant part: "An acceptor of a draft is obliged to pay the draft (i) according to its terms at the time it was accepted, even though the acceptance states that the draft is payable 'as originally drawn' or equivalent terms . . . ." U.C.C. § 3-413 (1990).

The "controlling language" in section 4-303 referred to by the court falls considerably short of being the necessary and sufficient condition for the displacement of article 5 by article 4. As was discussed in connection with *Banco Bamerindus*, the payor bank referred to in section 4-303 is an article 4 bank—it is the last bank in the collection chain of article 4 items, not the issuing or confirming bank of a letter of credit, although in some instances both capacities may merge. Where a draft is sent for collection and the collecting bank presents it as a collection item to the issuing bank-payor and the issuing bank *then* pays in cash or issues an acceptance or certification as a means of payment for the draft-item, such an issuing bank-payor could be subject to section 4-303. However, these were not the facts of *Gotham* or *Banco Bamerindus*.

In the absence of a necessary and sufficient basis, the *Gotham* court attempted to justify the application of article 4 by means of subsidiary arguments. However, these attempts fall victim to the same faulty logic as their predecessors. First, the court argued that

the legislature enacting Article 5 made it clear that Article 5 and the UCP do not control "every aspect of a transaction that involves a letter of credit" when it provided that Article 5 was intended to deal with "some but not all of the rules and concepts of letters of credit." Accordingly, Section 4-303 by its terms supersedes 5-114 . . . ."<sup>133</sup>

Despite the court's use of "accordingly," it does not follow that because the legislature did not intend article 5 to be exhaustive it must have intended article 5 rules to be displaced by rules in other articles. It is one thing for a court to fill in legislative gaps with general principles of law or of equity or with certain statutory or customary rules. It is completely different for a court to contend that although an article 5 rule exists, such as section 5-114, it should be disregarded in an article 5 transaction because section 4-303 also exists.

### C. *The Public Policy of Gotham*

Finally, the New York Court of Appeals attempted to but-

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<sup>133</sup> *Gotham*, 64 N.Y.2d at 295, 475 N.E.2d at 1260, 486 N.Y.S.2d at 719 (emphasis added).

stress its logic with "important policy considerations."<sup>134</sup> The main consideration was that bankers' acceptances are regularly sold to obtain financing before the date of maturity of the acceptance in "a market sanctioned by the Federal Reserve Board."<sup>135</sup> The *Gotham* court ominously concluded that "[i]f the courts intervene to enjoin issuing banks from paying drafts they have previously accepted they seriously undermine *this market*."<sup>136</sup>

The court of appeals mistakenly connected the drafts in First Commercial's hands with a Federal Reserve Board "sanctioned" market. Assuming that a valid and operative acceptance was created by Bank Leumi, nothing in *Gotham* indicates that Bank Leumi's purported acceptance ever entered the market sanctioned by the Federal Reserve Board. The sanctioned acceptance market comprises discounts by a Federal Reserve Bank and purchases of acceptances by bank members of the Federal Reserve System. This market presupposes a sale of the acceptance by the beneficiary or the collecting bank to a bank member of the Federal Reserve System. Thus, an acceptance that remains with the accepting bank, the beneficiary or the collecting bank has not entered the Federal Reserve sanctioned acceptance market. Moreover, to enter this market by means of a discount, rediscount or purchase, the acceptance must fulfill certain requirements, found in section 13 of the Federal Reserve Act:

Upon the indorsement of any of its member banks, with a waiver of demand, notice and protest by such bank . . . any Federal reserve bank may discount notes, drafts and bills of exchange arising out of actual commercial transactions; . . . the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Chapter.<sup>137</sup>

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<sup>134</sup> *Id.* at 297, 475 N.E.2d at 1261, 486 N.Y.S.2d at 721.

<sup>135</sup> *Id.* (emphasis added).

<sup>136</sup> *Id.* (emphasis added).

<sup>137</sup> Federal Reserve Act, ch. 6, § 13 (1913). In the event of a rediscount, the same section provides:

Any Federal Reserve Bank may discount acceptances which are based on the importation or exportation of goods and which have a maturity time at the time of discount of no more than three months, and indorsed by at least one member bank. The amount of acceptances so discounted shall at no time exceed one-half the paid-up capital stock and surplus of the bank for which the rediscounts were made. The aggregate of such notes and bills bearing the signature or indorsement of any one person, company, firm or corporation rediscounted for any one bank shall at no time exceed ten percentum of the

A foreign bank's acceptance will enter the Federal Reserve sanctioned market only if the issuing entity was a United States branch or agency of the foreign bank.<sup>138</sup> While the Federal Reserve Bank may receive deposits from and discount paper endorsed by any branch or agency of the foreign bank in the same manner and to the same extent as any member bank, such a branch or agency must maintain the required reserves with the Federal Reserve Bank.<sup>139</sup> Bank Leumi's acceptance, therefore, would have to meet several intrinsic and extrinsic requirements before it could enter the Federal Reserve System sanctioned market. The *Gotham* opinion is silent on whether these requirements were met by Bank Leumi's purported acceptance. In the absence of specific findings, it would be unwarranted to assume that the issuer of the acceptance met these requirements.

Furthermore, even if the acceptance met the requirements for entrance in the Federal Reserve sanctioned market, there would be no reason for applying U.C.C. section 4-303.<sup>140</sup> U.C.C. section 5-114(2)(a) was specifically designed for the protection of holders in due course of a beneficiary's draft, such as the member bank that purchased or the Federal Reserve Bank that discounted or re-discounted R. Bore's drafts.<sup>141</sup> If the court of appeals had in mind a market in which drafts were not purchased or discounted by members of the Federal Reserve System but merely were retained by issuing banks, beneficiaries or their agents, it is difficult to see why this market should be given any greater protection than that afforded by U.C.C. article 5. After all, if a beneficiary is concerned about what might happen from the time a bank accepts a draft to the time it pays for it, article 5 and the UCP provide the beneficiary with easy alternatives. First, he may insist on a credit payable upon presentation of a "sight" draft.<sup>142</sup> Second, if he wishes to extend credit to his

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unimpaired capital and surplus of said bank . . . .

*Id.* (emphasis added).

<sup>138</sup> The Federal Reserve Act, as amended in 1978, refers only to transactions between a Federal Reserve Bank and a *branch or agency* of a foreign bank. See 12 U.S.C. § 347, Publ. L. 95-369, § 7(b), 92 Stat. 621, Sept. 17, 1978.

<sup>139</sup> *Id.*

<sup>140</sup> See *supra* note 25.

<sup>141</sup> See *supra* note 4 and accompanying text.

<sup>142</sup> See UCP art. 10(a)(1); U.C.C. § 5-114(4)(b) (as amended in 1977) (limiting the issuer's time of rejection to "three banking days following its receipt of the documents"). See also UCP art. 16(c) (imposing a "reasonable time" limitation).

buyer and to protect himself against an unwarranted injunction, he may agree to a time letter of credit, but will negotiate his draft with a true negotiating bank as soon as possible. The true negotiating bank will qualify as a holder in due course and, contrary to what First Commercial was prepared to do with R. Bore's account in *Gotham*, would not seek recourse against the beneficiary or transferee.

The remaining beneficiaries in such a non-Federal Reserve sanctioned market, then, would be (A) a good faith beneficiary who wishes to take the risk of holding the draft until maturity in exchange for not having to pay a negotiation commission and fee, and (B) a bad faith beneficiary who knows he has committed fraud but counts on *Gotham* and *Banco Bamerindus* to obtain his ill-gotten payment. Public policy does not require that these beneficiaries receive additional protection under article 5. Beneficiary A is not only assuming a risk for a consideration he deems significant, but also, if the documents are genuine and he has not committed fraud, the issuing or the confirming bank will eventually have to pay its accepted draft. In addition, Beneficiary A stands to recover damages from the applicant, especially when most courts in the United States require the posting of a bond large enough to cover precisely the damages suffered as a result of the delayed payment.<sup>143</sup> Beneficiary, on the other hand, does not deserve any protection beyond that afforded by the criminal justice system.

Another case helps to clarify the public policy of protecting payees of letter of credit-like promises. In *Da Silva v. Sanders*,<sup>144</sup> the court considered an attempt by a bank that issued a cashier's check to dishonor it on grounds of fraud or no consideration. Unlike *Gotham* and *Banco Bamerindus*, however, in *Da Silva* the payee of the cashier's check was innocent of fraud. After describing the split of authority on the issuing bank's liability toward payees on fraudulently obtained cashiers' checks,<sup>145</sup> the district court expressed its preference for protecting the payee, even though not the holder in due course of the cashier's

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<sup>143</sup> See *Rockwell International Systems, Inc. v. Citibank N.A.*, 719 F.2d 593, 589-90 (2d Cir. 1983).

<sup>144</sup> 600 F. Supp. 1008 (D.D.C. 1984).

<sup>145</sup> *Id.* at 1011.



check, against the "four legals" of U.C.C. section 4-303.<sup>146</sup> The policy behind its choice was "to permit the continued expansion of commercial practices through custom and usage,"<sup>147</sup> especially when cashiers' checks have come to be viewed as cash in the marketplace. Despite its alignment with the "cash like" view of cashiers' checks—a view which is not without sound detractors—the district court warned that:

This is not the case where the payee of the cashier's check *deals directly with the bank and engages in some fraud to obtain issuance of the check from the payor bank or there has been a lack of consideration running from the payee that deals directly with the payor bank* . . . . Under such circumstances, several courts have noted that "strong considerations of public policy favoring negotiability and reliability of cashiers' checks are not present and therefore a bank may refuse payment."<sup>148</sup>

One of the nation's most respected regulators of bankers' acceptances, Mr. Walker Todd with the Federal Reserve Bank of Cleveland, agrees with *Da Silva's* warning and with its analogous application to bankers' acceptances.<sup>149</sup> According to Todd, it is appropriate for bank examiners to require that acceptances be counted as liabilities outstanding of the accepting bank from the moment that "the acceptance hits the paper."<sup>150</sup> A bank examiner concerned with a realistic assessment of the *likelihood of liability* is well advised to count the acceptances left in the possession or control of the beneficiary as outstanding liability. However, the function of an adjudicator in court is different than that of a bank examiner. A court must determine the parties' rights and duties at the time of trial. Todd agrees with this writer that from a judicial vantage point:

As between the bank and the beneficiary, their legal status (*i.e.* their rights and duties) does not change as long as the acceptance remains with the beneficiary or subject to his control. Thus, from a regulatory standpoint, the banks' liabilities outstanding cannot increase as long as the accepted draft is in the hands of the beneficiary or in the pos-

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<sup>146</sup> See *supra* notes 24-25 and accompanying text.

<sup>147</sup> *Da Silva*, 600 F. Supp. at 1013.

<sup>148</sup> *Id.* at 1013 n.13 (emphasis added).

<sup>149</sup> Telephone interview with Walker Todd, Esq., Assistant General Counsel and Research Officer, Federal Reserve Bank of Cleveland (Sept. 15, 1992).

<sup>150</sup> *Id.*

session of the bank, and subject to no third party's instructions.<sup>151</sup>

The judicial and regulatory distinction between negotiated and non-negotiated acceptances, or acceptances that remain with the beneficiary or his collecting agent and those in the hands of a holder in due course, reveals the misdirection of the New York Court of Appeals' public policy justification. The same distinction that Todd and this writer draw prevails in the law of Europe's major financial centers.<sup>152</sup>

#### D. *A Brief Comparative Law Excursus*

Some of Europe's most respected and influential commercial and banking lawyers characterized *Banco Bamerindus* and *Gotham* as contrary to their own laws.<sup>153</sup>

##### 1. England

Professor Roy Goode of Oxford University in England noted that under English law, once a draft is presented and accepted, the claim on the letter of credit is replaced by a claim on the draft governed by negotiable instruments law.<sup>154</sup> Under English negotiable instruments law a sharp distinction is drawn between

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<sup>151</sup> *Id.*

<sup>152</sup> See *infra* notes 153-75 and accompanying text.

<sup>153</sup> These opinions were obtained during two meetings attended by this writer during the summer of 1992. The first meeting was of the International Chamber of Commerce Working Group for the revision of the UCP and took place in Rome from August 10-13, 1992. The *Banco Bamerindus* and *Gotham* decisions were discussed with Professor Salvatore Maccarone of the University of Rome, Vice President of the ICC Banking Commission and Representative of the Italian Bankers Association for the Revision of the UCP, and with Joachim Weichbrodt, Legal Counsel and Syndikus for the Dresdner Bank, and German Representative to the ICC Banking Commission and for the revision of the UCP. The second meeting was of the International Academy of Commercial and Consumer Law and it took place in Stockholm from August 18-23, 1992. In Stockholm the above mentioned decisions were discussed with Professor Roy Goode, Norton Rose Professor of English Law at St John's College, Oxford, Professor Jean Stoufflet, Honorary Dean and Professor of Commercial and Banking Law at Clermont Ferrand and University of Paris, and with Professor Dr. W. Frhr. von Marschall, Director of the Institut für Internationales Privatrecht und Rechtsvergleichung at Bonn University. (Text on file with the *Brooklyn Law Review* and with the Documentation Center at the University of Arizona Foreign Law Library Documentation Center of the International Academy of Commercial and Consumer Law.).

<sup>154</sup> Letter from Roy Goode, Norton Rose Professor of English Law, St. John's College, Oxford, England, to Professor Boris Kozolchyk, College of Law, University of Arizona (Sept. 9, 1991) (on file with the *Brooklyn Law Review*).

a holder in due course and other holders.<sup>155</sup> This distinction applies to holders of letters of credit drafts as well:

Suppose that by reason of fraud in the transaction, it (the accepting bank) never had a liability to pay against the documents. Can it not be said that the supposed value failed and that the beneficiary as original holder is precluded from enforcing payment against the instrument? . . . Obviously the argument could not be advanced against a holder in due course. But why cannot it be advanced against the original holder who was, *ex hypothesi*, the fraudulent beneficiary purporting to give value (discharge of his claim on the letter of credit) when in fact he gave none?<sup>156</sup>

## 2. France

Professor Jean Stoufflet of the Universities of Clermont Ferrand and Paris, France also concluded that the acceptance, once created, is subject to negotiable instruments law. Like English law, French negotiable instruments law provides that neither the applicant nor the acceptor-bank may raise the defense of fraud against the holder in due course of the acceptance.<sup>157</sup> Yet if the

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<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> If the draft is in the hands of a holder in due course (for example the bank that has discounted it), this holder is protected by the principle of unavailability of defenses set forth in article 121 of the French Commercial Code (derived from the Geneva Convention of 1930). No defense derived from the underlying transaction, can be raised, including the defense of fraud . . . In contrast, if the holder is a party to the underlying transaction, the defenses of lack of performance and other defenses grounded on this transaction remain available and will justify the refusal of payment of the draft. . . It follows, that if the draft in question was accepted not by a bank but by the buyer himself, fraud may be invoked and an injunction is certainly possible under French law. . . Would this [conclusion] be different because the bank was the acceptor of the draft? In my opinion, fraud should equally paralyze the payment claim y the seller for two reasons. In reality, fraud vitiates the entire transaction: The commercial transaction and the banking transaction [the letter of credit agreement]. The rule "fraud corrupts everything" applies. . . I would add that the [beneficiary's] commercial performance is the counterpart (consideration) for the bank's acceptance. In reality, in a letter of credit transaction the bank pays a buyer's debt to the seller, even though the peculiar mechanism of the letter of credit creates a certain level of abstraction. At that moment, the fraud affecting the commercial performance is a valid basis to refuse payment of the draft if payment, it ought to be repeated, is claimed by the seller himself, [the] author of the fraud, and not by a holder in due course.

Letter from Jean Stoufflet, University of Clermont Terrand and University of Paris to Professor Boris Kozolchyk, University of Arizona, College of Law 3-4 (Sept. 16, 1992) (as translated by author)(on file with the *Brooklyn Law Review*).

holder of the acceptance is a party to the underlying transaction, the defense of lack of performance "and other defenses grounded on this transaction remain available and will justify the refusal of payment of the draft."<sup>158</sup> Unquestionably, if the acceptor were the buyer himself, French law would allow him to enjoin the seller's collection of the draft. Under French law the same result would be obtained if the bank were the acceptor because under French law "fraud corrupts everything": a beneficiary's performance is ultimately the consideration for the bank's acceptance. Accordingly, under French law the fraud that vitiates the beneficiary's performance is a valid basis to refuse payment of the draft when payment is claimed by the seller-author of the fraud, and not by a holder in due course.<sup>159</sup> Professor Stoufflet also questions whether an acceptance was ever created by Banco in *Banco Bamerindus*, especially if the draft was retained by the bank.<sup>160</sup>

### 3. Germany

Professor Wolfgang von Marschall and banking lawyer Joachim Weichbrodt agree that *Banco Bamerindus* and *Gotham* are contrary to German law.<sup>161</sup> According to Professor von Marschall, it is generally accepted in German law that the issuing bank may refuse to honor a letter of credit in the case of actual fraud by the beneficiary.<sup>162</sup> The latest edition of J. Zahn's authoritative commentary on letter of credit law, however, maintains that the buyer-applicant cannot enjoin the issuing bank once that bank has accepted the beneficiary's draft.<sup>163</sup> Professor

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<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> In Professor Stoufflet's words: "After its acceptance, the draft was not immediately sent to the beneficiary but was retained by the bank. Could it not be maintained that until the restitution of the draft to the beneficiary that there was no real acceptance?" *Id.* at 3.

<sup>161</sup> Letter from Wolfgang F. von Marschall, Direktor, Institut Fur Internationales Privatrecht und Rechtsvergleichung to Professor Boris Kozolchyk, University of Arizona, College of Law (Sept. 8, 1992) (on file with the *Brooklyn Law Review*).

<sup>162</sup> See *id.* For a survey and analysis of German decisions enjoining presumed fraudulent beneficiaries of bank guarantee drafts or demands for payment, see Boris Kozolchyk, *Bank Guarantees and Letters of Credit: Time for Return to the Fold*, 11 U. PA. J. INT'L BUS. L. 1, 44-50 (1989).

<sup>163</sup> ZAHN, *supra* note 45, at 234-36. The justification for this viewpoint seems to be that once the acceptance is executed the letter of credit relationship (*Akkreditiv-verhältnis*) ceases to exist and thus there is nothing to enjoin. This is a mistaken concep-

von Marschall suggests a possible explanation of Zahn's viewpoint by restricting the unavailability of the injunction to fraud "with regard to the letter of credit."<sup>164</sup> Arguably such a restriction would not preclude an injunction if the fraud pertains to the underlying transaction. Whatever the scope of Zahn's suggested restriction, Professor von Marschall asserts that under the Geneva Convention for Bills of Exchange and Promissory Notes (as ratified by Germany)<sup>165</sup> and under the more recent Convention on International Bills of Exchange and Promissory Notes ("UNCITRAL"),<sup>166</sup> the fraudulent beneficiaries in *Banco Bamerindus* and *Gotham* would be subject to an injunction.<sup>167</sup>

Weichbrodt points out that German courts and commentators overwhelmingly maintain that the first holder of the draft who is also the payee in the underlying transaction cannot avail himself of Article 17 of the Geneva Convention and of the German bill of exchange law.<sup>168</sup> This Article prevents "persons sued on the bill of exchange" from raising defenses against holders of the draft based upon their relations with the drawer or previous holders.<sup>169</sup> Article 17, therefore, would not apply to the beneficiaries in *Banco Bamerindus* and *Gotham* and these beneficiaries would be subject to the defense of fraud or to a fraud-based injunction, provided that fraud was clearly established by

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tion of the extinction of letter of credit liability in general and with respect to transferable-negotiable credits in particular. See *supra* notes 86-88 and accompanying text.

<sup>164</sup> See von Marschall's Letter, *supra* note 161, at 1.

<sup>165</sup> *Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes, Signed at Geneva, June 7, 1930*, 143 L.N.T.S. 257 (1933-34) ("Geneva Convention"). The Conventions adopted by the League of Nations included a uniform law for bills of exchange and promissory notes and two additional conventions for the settlement of conflict of laws and on stamp laws on bills of exchange and promissory notes. Among the states that ratified the three Geneva conventions were Austria, Belgium, Brazil, Denmark, Finland, France, Germany, Hungary, Italy, Japan, Luxembourg, Monaco, Netherlands, Norway, Poland, Portugal, Soviet Union, Sweden and Switzerland.

<sup>166</sup> See Report of the Secretary General, UNCITRAL Document A/CN.9/281, Apr. 23, 1986 (precedes the final adoption). On the UNCITRAL convention, see Wolfgang von Marschall, *UNCITRAL's Proposed International Bill of Exchange*, 1987 ARIZ. J. OF INT. COMP. L. 6 (1987).

<sup>167</sup> See von Marschall's Letter, *supra* note 161.

<sup>168</sup> Letter from Syndicus Joachim G. Weichbrodt to Professor Boris Kozolchyk, University of Arizona, College of Law (Aug. 21, 1992) (on file with the *Brooklyn Law Review*).

<sup>169</sup> Article 17 of the Geneva Convention, as ratified by Germany, provides: "Persons sued on a bill of exchange cannot set up against the holder defenses founded on their personal relation with the drawer or with previous holders, unless the holder in acquiring the bill has knowingly acted to the detriment of the debtor." *Id.*

what German courts and commentators refer to as "liquid proof" ("*liquide beweis*").<sup>170</sup>

#### 4. Italy

Professor Salvatore Maccarone of Rome University agrees with the preceding opinions. He points out that under Italian law, as with the law of other Geneva Convention countries, only when the first holder or payee endorses the draft to a third party does the obligor's promise become independent from the underlying transaction and subject to the special regime of negotiable instruments law defenses.<sup>171</sup> In other words, *vis-a-vis* the payee or first holder (the "immediate" party in the relationship obligor-payee or first holder), the undertaking of the obligor (acceptor of the draft) remains the same.<sup>172</sup> Thus defenses such as error, duress or fraud cannot be raised against a remote holder (holder in due course), but may be raised against the immediate holder. Moreover, according to the prevailing view, the defense of fraud may be raised against a bad faith holder (not necessarily the first holder) who, although not the author or perpetrator of the fraud, knew of the fraud when acquiring the draft.<sup>173</sup> Under Italian law the reason for extending the availability of the fraud defense is that knowledge of fraud undermines the very

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<sup>170</sup> See Weichbrodt's Letter, *supra* note 168. The following decisions and comments submitted by Weichbrodt illustrate the vulnerability of the payee or first holder of the accepted draft against defenses personal to the obligor as well as those arising from the underlying transaction in German decisional law and commentary.

15) "Against the payee or direct taker, the obligor can raise all objections, and it does not matter whether they are based on [lack of] formality or [they are] personal or real objections. . . [provided] he is not a holder in due course. . ." WOLFGANG HEFERMEHL & ADOLF BAUMBACH, *Wechselgesetz und Scheckgesetz* par.67 (1984). For an illustration of the prevailing judicial attitude, see BGH, Urt. v. 30.1. 1986- II ZR 257/85 (OLG Stuttgart) (holding that a German buyer who has accepted a draft for the payment of the purchase price of goods is able to raise against the seller and first holder of the draft the defense of insufficiency of consideration (unless otherwise agreed by him). This defense can also be raised against a third party who has taken the draft in payment of the buyer's purchase price.

*Id.*

<sup>171</sup> Letter from Professor Salvatore Maccarone to Professor Boris Kozolchyk, University of Arizona, College of Law (Sept. 14, 1992) (on file with the *Brooklyn Law Review*).

<sup>172</sup> But see Maccarone's Letter, *supra* note 171 (citing a contrary, minority point of view among Italian scholars).

<sup>173</sup> See Maccarone's Letter, *supra* note 171, at 4.

notion of *bona fide* acquisition.<sup>174</sup> This defense, therefore, would benefit not only the drawer but also the acceptor bank. Professor Maccarone concludes:

Once the drawer has notified the acceptor of the fraud, the acceptor's own obligation would enjoy the fraud exception for the reason I just gave, *i.e.*, that the defense does not arise from [their] personal relationship but from the instrument itself and therefore undermines the right of the bad faith holder to obtain payment from any party to the instrument. In sum, I believe that the Court was wrong in the case in question stretching beyond reasonableness the abstraction of negotiable instrument undertakings.<sup>175</sup>

## CONCLUSION

Even though the United States is not a party to the Geneva Convention, its statutory law and, until *Gotham* and *Banco Bamerindus*, its decisional law have been consistent with the Convention's distinction between defenses against a payee or first holder and a holder in due course. U.C.C. section 3-305, which continues to be in force in New York, distinguishes between the defenses of "any party to the instrument with whom the holder has not dealt," and, *a contrario*, those by a party with whom the holder in due course has dealt.<sup>176</sup> White and Summers note that, because U.C.C. section 3-305 permits a holder to take free of defenses only of a party to the instrument with whom the holder has not dealt with, most payees will not

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<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> U.C.C. section 3-305 as in force at the time of the *Gotham* and *Banco Bamerindus* decisions provides, in relevant part as follows:

To the extent that a holder is a holder in due course he takes the instrument free from

- (1) all claims to it on the part of any person; and
- (2) all defenses of any party to the instrument with whom the holder has not dealt except
- (c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; . . .

N.Y.U.C.C. § 3-305 (1991). One of this section's predecessors was section 58 of the Uniform Negotiable Instruments Law, which in relevant part stated: "In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were non-negotiable . . ." *Id.* The Negotiable Instruments Law was promulgated by the National Conference of Commissioners of Uniform State Laws in 1896, and by 1924 had been adopted, with minor variations, in all states.

take free of the drawer's or maker's defenses. This is true "even when these payees are holders in due course, for they will have dealt with the drawer or maker. In most cases, therefore, a payee holder in due course will not enjoy the most significant advantage accorded one in his shoes."<sup>177</sup>

It should be noted that the same court of appeals that decided *Gotham* authored a landmark decision on defenses available against a presumably fraudulent beneficiary approximately seventy years earlier. In *Maurice O'Meara Co v. National Park Bank of New York* ("O'Meara")<sup>178</sup> the New York Court of Appeals had to decide whether an issuing bank was justified in refusing the beneficiary's sight drafts if the "paper, when delivered, did not correspond to what had been purchased in weight, kind or quality."<sup>179</sup> The majority of the court of appeals decided that whether the paper was what the purchaser contracted to purchase did not concern the bank. The court stated that:

The bank was concerned only in the drafts and documents accompanying them . . . . If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for . . . .<sup>180</sup>

As was his habit, Justice Cardozo engaged in a more nuanced analysis than that of his peers.<sup>181</sup> In his dissent Cardozo distinguished between the absence of a duty to inquire into weight, kind or quality of goods and an absolute duty to pay

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<sup>177</sup> See WHITE & SUMMERS, *supra* note 69, at 636-37; see also *Hall v. Westmoreland, Hall & Bryan*, 182 S.E.2d 539 (Ga. 1971); Riegert, *supra* note 85, at 141. U.C.C. section 3-305, as discussed in the text, is still in force in New York. See N.Y.U.C.C. § 3-305 (McKinney 1991). The 1990 Official Text of the U.C.C., however, contains a substantially changed (and not altogether clear) text of U.C.C. section 3-305. It would appear that under the new text of section 3-305 a beneficiary who fraudulently induced a bank to accept a draft may be subject to the signer-acceptor's defense of fraud granted by section 3-305(a)(1). Similarly, personal defenses between the drawee-obligor and the original payee may be available under section 3-305(a)(3). Official Comment 2 to subsection (a)(2) refers to these defenses as cut off by a holder in due course. Presumably, therefore they are not cut off by an original payee or holder not in due course. Unfortunately, the language used in the 1990 redrafting of many article 3 sections is so casuistic that the proverbial forest is lost in the trees.

<sup>178</sup> 239 N.Y. 386, 146 N.E. 636 (1925).

<sup>179</sup> *Id.* at 396, 614 N.E. at 639.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.* (Cardozo, J., dissenting).



when the bank knew or had reason to believe that the goods were not of the kind, quality or weight represented by the beneficiary. It simply did not follow from the absence of a duty of concern with the merchandise that if the bank found that the merchandise was not what the documents described, it was still forced to pay "irrespective of its knowledge."<sup>182</sup> Rather than artificially inferring absolute duties from legalistic conceptions of banking and commercial reality, Cardozo strived for an accurate version of the transactional context, especially of the parties' relationship. Hence, he concluded:

We are to bear in mind that this controversy is not between the bank on one side and on the other a holder of the drafts who has taken them without notice and for value. The controversy arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated payment may be resisted if the documents are false . . . . I think the conclusion is inevitable that a bank which pays a draft upon a bill of lading misrepresenting the character of the merchandise may recover the payment when the misrepresentation is discovered . . . . If payment might have been recovered the moment after it was made, the seller cannot coerce payment if the truth is earlier revealed.<sup>183</sup>

Two public policies inhere in Justice Cardozo's conclusions. The first is that courts must do their utmost to prevent or correct inequity, particularly the inequity that results from treating unequals as equals. Second, courts must further procedural economy. The manner in which this great jurist went about implementing his public policies is educational for any adjudicator, whether a judge, administrator or legislator. To bring about equality of treatment, the adjudicator must first establish an accurate transactional context, what Cardozo referred to as "the true nature of the transaction,"<sup>184</sup> to characterize the legal status of the disputants. Once the transactional context and status of the disputants is established, the adjudicator can determine whether the rules in question are intended for such a dispute. A rule that prevents the bank from raising fraud as a defense is intended for the protection of a holder in due course and not for a party that "deals" with the bank. The beneficiary, unlike a holder in due course, "deals" with the bank when he receives

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<sup>182</sup> *Id.* at 401, 614 N.E. at 641 (Cardozo, J. dissenting).

<sup>183</sup> *Id.*

<sup>184</sup> *Id.*

money from the bank in exchange for his tender of documents representing that the goods are as described and allowing or inducing the bank's reliance on its documents as collateral. The beneficiary is protected by the principle of independence but this protection is not given to the fraudulent beneficiary. A rule that establishes priorities between acts of final payment or akin to final payment and the "four legals" doctrine is intended to protect the firming up of provisional settlements and the finality of payment of collection items. It is not intended to protect holders of unnegotiated and uncollected letter of credit drafts, especially when the holder is presumably a fraudster. Finally, procedural economy dictates that an adjudicator not decide the matter before it in a manner inconsistent with its own inevitable future decisions merely because the matter will be brought up in a different procedural setting.

Cardozo's *O'Meara* dissenting opinion has withstood the test of time. Section 5-114, perhaps the most invoked provision in connection with current letter of credit litigation, bears the imprint of Cardozo's *O'Meara* dissent.<sup>185</sup> As demonstrated in the preceding analysis, the context of the *Banco Bamerindus* and *Gotham* time drafts (accepted or not as the draft in the latter case may have been) is that of U.C.C. section 5-114. To reject this rule is to ignore the true transactional context and to encourage the perpetration of inequity.

To reject section 5-114 also encourages costly procedural duplication. If an egregious fraud allows recovery against the same beneficiary by the same applicant or bank in a subsequent proceeding, and if the harm could well be irreparable, there is no justification to postpone. Conversely, if an adequate bonding requirement ensures the recovery of good faith beneficiaries against unwarranted injunctions, nothing justifies assuming that

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<sup>185</sup> See U.C.C. § 5-114 cmt. 2. During March 1960, while this writer was researching his dissertation on comparative letter of credit law, he had occasion to visit with Karl Llewellyn and Soia Mentschikoff at the University of Chicago Law School. During one of these visits, Soia Mentschikoff indicated that Justice Shientag's opinion in *Sztejn v. Schroder Banking Corporation*, 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. N.Y. County 1941) had been highly influential in the drafting of U.C.C. section 5-114. Yet when this writer mentioned that Justice Shientag's *ratio decidendi* seemed to have been inspired by Judge Cardozo's dissent in *O'Meara Co. v. National Park Bank of New York*, 239 N.Y. 386, 146 N.E. 636 (1925), Karl Llewellyn exclaimed: "Of course, who could doubt that? Cardozo saw things earlier and better than the rest of them . . . . In many ways we are all his children . . . ."

beneficiaries are unprotected and denying injunctions against an entire class of letters of credit drafts, i.e., those which have not been negotiated.

To the extent that drafts held by beneficiaries or their collecting agents are part of any market, such a market would still be protected by U.C.C. section 5-114. Conversely, the unavailability of section 5-114 would undermine the market for New York confirmations of foreign issuances. Consider the predicament of a New York confirming bank in a *Banco Bamerindus* type of situation: if it obeys New York and Second Circuit law, as it must, it will risk losing reimbursement not only under the laws of Brazil, but also of England, France, Germany and Italy, among many others.

*Gotham* and *Banco Bamerindus* reinforce the existing worldwide trend among confirming banks of requiring prepayment or full collateralization of each confirmation. This trend discourages the extension of credit among correspondent banks, one of the most significant benefits of the correspondent banking relationship. In light of these considerations, the Second Circuit and the New York Court of Appeals, as well as other courts that have followed *Gotham* and *Banco Bamerindus*, would be well advised to reconsider their rejection of U.C.C. section 5-114. Similarly, the National Conference of Commissioners of Uniform State Laws, presently in the midst of revising article 5, should make it a high priority to restore the vigor of section 5-114 (among other sections) by clarifying the interaction of article 5 with, among others, article 4.<sup>186</sup>

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<sup>186</sup> See Boris Kozolchyk, *The Paperless Letter of Credit and Related Documents of Title*, 55 LAW & CONTEMP. PROBS. 39, 70-77 (1992).