CHAPTER II

THE LAW OF INTERNATIONAL TRADE AND INVESTMENT

A. THE TRADE TRANSACTION ITSELF

A trader faces a variety of special problems in carrying out business when that business is international. It is necessary to deal at long distance with people whom the trader may not know personally. If a conflict arises, the legal systems of the different parties may provide different answers. Moreover, each may regard the other's courts as likely to be unfair; even if a foreign court is fair, using it may be extremely expensive.

Those involved in transnational sales transactions, therefore, have developed a variety of specialized devices to reduce their risks. For example, the London insurance companies, complete with global registers of ships, have long offered ways to deal with loss on the high seas. International arbitration has become available as a relatively neutral and inexpensive forum for the settlement of unavoidable disputes. Multilateral projects have encouraged the development of harmonized laws and regulations, practices and principles with respect to international trade. These devices and the associated bodies of law are developing rapidly with increased international trade, with the evolution of transportation mechanisms such as containerization, and, most of all, with the evolution of instantaneous computer-based global communications and fund transfer.

Many of these devices are beyond the scope of this text.[1] Some specific practices, however, are central to the mechanisms of trade. These include ways to reduce the risks of contractual misunderstanding, to make sure that sellers actually ship goods, and to give sellers confidence that buyers will actually pay. Such arrangements are not always needed; in much international trade, a firm trades with its own subsidiary or a government undertakes the credit risks of an export. Yet, in another large portion of trade, the special institutions are used, and they are unfamiliar enough to deserve attention here.

1. The Trade Transaction and the Letter of Credit Procedure

There are many ways to conduct international trade transactions, and the financing structures need be no more formal than that used in domestic trade, especially when a firm is buying from or selling materials to its foreign subsidiary. Nevertheless, the most typical pattern for agreements between strangers is the letter of credit transaction, which involves four elements:

Internationally agreed standard trade contracts are detailed understandings, accepted

1. For extensive analysis of the institutions of international arbitration, see Gary B. Born, International Commercial Arbitration in the United States (2d ed. 2001).

throughout the world, that allocate the risks and costs of a transaction, and can easily be incorporated by reference in an international sales contract.

The bill of lading is a contract between the shippers and the shipping company that serves also as a receipt indicating that the shipping company has actually received the goods, and as evidence of title to the goods specified in the bill.

The letter of credit is a promise by a bank to make a specified payment under particular and well-defined circumstances.

The documentary draft is a negotiable instrument (a check is a simple, typical example of a negotiable instrument) by which payment can actually be accomplished.

Each of these elements plays a role in reducing the risks of the transaction. The trader can use the standard trade contract to avoid misunderstandings with his or her foreign counterpart. The bill of lading becomes a way for the buyer to be able to rely on the shipping company, which will usually be easily accessible to all parties, for a guarantee that goods have actually been shipped. The letter of credit enables the seller to rely on a bank's international reputation for a guarantee that payment will actually be made. And, finally, although it is used in part for historical reasons only, the draft permits integration of the payment process into the regular bank clearing system and can also be used in extending short-term credit. In the transaction as traditionally structured, the last three of these elements are actual pieces of paper, and the transaction will be explained in those terms. Nevertheless, you should be warned that in many trade transactions today, these pieces of paper are often replaced by electronic communications serving the same, or very similar, functions.

a. The Sales Contract

The central issues in the contract itself are those surrounding the allocation of costs and risks. Insurance and freight costs are often large enough that it is very important to know whether or not a quoted price includes those costs. Moreover, the parties must be clear who is responsible for obtaining insurance and who is to bear the risk of an uncompensated loss.

For international sales purposes, the key source of law is now the U.N. Convention on the International Sale of Goods (CISG), negotiated by the U.N. Commission for International Trade Law (UNCITRAL).[2] The CISG, which entered into force in the United States in 1988, is automatically applicable to international transactions between parties located in two CISG states unless the parties agree otherwise. The CISG includes some surprises; for example, its battle-of-the-forms provisions are quite different from those of the Uniform Commercial Code's Article 2.[3] Supplementing this treaty are

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2. The text of the CISG is available at 19 I.L.M. 668 (1980) and it is also codified at 15 U.S.C. App.

3. For background and discussion, see J. Honnold, Uniform Law for International Sales Under the 1980 United Nations Convention (1982); H. Gabriel, *The Battle of the Forms: A Comparison of the United Nations Convention for the International Sale of Goods and the Uniform Commercial Code: The Common Law and the Uniform Commercial Code*, 49 Bus. Law. 1053 (1994); Honnold, *The Sales Convention: Background, Status, and Application*, 8 J. Law and Commerce 1 (1988); A. Rossett, *Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods*, 45 Ohio State L.J. 265 (1984); *Symposium on International Sale of Goods Convention*, 18 Intl. Law. 3 (1984); *UNCITRAL Symposium*, 18 Intl. Law. 3 (1984). One of the first U.S. cases discussing the Convention is *Filanto v. Chilewich International Corp.*, 789 F.Supp. 1229 (S.D.N.Y. 1992), which considered using the Convention's "battle-of-the-forms" rule to require arbitration in Russia. Since it first entered into force, the CISG has been cited or applied in hundreds of international trade cases worldwide, although surprisingly few in U.S. courts. For discussion of the CISG in the courts, and extensive supporting analytical tables, see Michael R. Will, CISG–The First 464 Decisions (1998) (finding only 13 U.S. decisions from 1988 through 1997).

standard agreement forms, developed by the International Chamber of Commerce, and now called "Incoterms." These terms permit easy referencing of detailed arrangements for a sale. There are a variety of available arrangements for different allocations of obligations, such as those of paying freight and insurance. Examples of two of the more common ones follow:

INTERNATIONAL CHAMBER OF COMMERCE GUIDE TO INCOTERMS (2000)

FOB FREE ON BOARD (. . . named port of shipment)

"Free on Board" means that the seller delivers when the goods pass the ship's rail at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that point. The FOB term requires the seller to clear the goods for export. This term can be used only for sea or inland waterway transport. If the parties do not intend to deliver the goods across the ship's rail, the ["Free Carrier"] term[a] should be used.

A. THE SELLER'S OBLIGATIONS

1. Provision of goods in conformity with the contract

The seller must provide the goods and the commercial invoice, or its equivalent electronic message, in conformity with the contract of sale and any other evidence of conformity which may be required by the contract.

2. Licenses, authorizations and formalities

The seller must obtain at his own risk and expense any export license or other official authorization and carry out, where applicable, all customs formalities necessary for the export of the goods. . . .

4. Delivery

The seller must deliver the goods on the date or within the agreed period at the named port of shipment and in the manner customary at the port on board the vessel nominated by the buyer.

5. Transfer of risks

The seller must, subject to the provisions of B5, bear all risks of loss of or damage to the goods until such time as they have passed the ship's rail at the named port of shipment.

6. Division of costs

The seller must, subject to the provisions of B6, pay

- all costs relating to the goods until such time as they have passed the ship's rail at the named port of shipment; and
- where applicable, the costs of customs formalities necessary for export as well as

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a. Under the "Free Carrier" term (FCA), seller fulfils its obligation to deliver when it has handed over the goods, cleared for export, into the charge of the carrier named by the buyer at the named place. FCA is used for any mode of transport, including multimodal transport and containerized shipping. ("Multimodal" means transport by more than one mode of transportation, e.g., by both ship and rail. *See generally* Stephen G. Wood, *Multimodal Transportation: an American Perspective on Carrier Liability and Bill of Lading Issues*, 46 Am. J. Comp. L. 403 (1998) (discussing multimodal transport).)

all duties, taxes and other official charges payable upon export.

7. Notice to the buyer

The seller must give the buyer sufficient notice that the goods have been delivered in accordance with A4.

8. Proof of delivery, transport document or equivalent electronic message

The seller must provide the buyer at seller's expense with the usual proof of delivery in accordance with A4.

Unless the document referred to in the preceding paragraph is the transport document, the seller must render the buyer, at the latter's request, risk and expense, every assistance in obtaining a transport document for the contract of carriage (for example, a negotiable bill of lading, a non-negotiable sea waybill, an inland waterway document, or a multimodal transport document).

Where the seller and the buyer have agreed to communicate electronically, the document referred to in the preceding paragraph may be replaced by an equivalent electronic data interchange (EDI) message.

9. Checking - packaging - marking

The seller must pay the costs of those checking operations (such as checking quality, measuring, weighing, counting) which are necessary for the purpose of delivering the goods in accordance with A4.

The seller must provide at his own expense packaging (unless it is usual for the particular trade to ship the goods of the contract description unpacked) which is required for the transport of the goods, to the extent that the circumstances relating to the transport (for example modalities, destination) are made known to the seller before the contract of sale is concluded. Packaging is to be marked appropriately.

10. Other obligations

The seller must render the buyer at the latter's request, risk and expense, every assistance in obtaining any documents or equivalent electronic messages (other than those mentioned in A8) issued or transmitted in the country of shipment and/or of origin which the buyer may require for the import of the goods and, where necessary, for their transit through another country.

The seller must provide the buyer, upon request, with the necessary information for procuring insurance.

B. THE BUYER'S OBLIGATIONS

1. Payment of the price

The buyer must pay the price as provided in the contract of sale.

2. Licenses, authorizations and formalities

The buyer must obtain at his own risk and expense any import license or other official authorization and carry out, where applicable, all customs formalities for the import of the goods and, where necessary, for their transit through any country.

3. Contracts of carriage and insurance

a) Contract of carriage

The buyer must contract at his own expense for the carriage of the goods from the named port of shipment.

b) Contract of insurance

No obligation.

4. Taking delivery

The buyer must take delivery of the goods when they have been delivered in

accordance with A4.

5. Transfer of risks

The buyer must bear all risks of loss of or damage to the goods

- from the time they have passed the ship's rail at the named port of shipment; and
- from the agreed date or the expiry date of the agreed period for delivery which arise because he fails to give notice in accordance with B7, or because the vessel nominated by him fails to arrive on time, or is unable to take the goods, or closes for cargo earlier than the time notified in accordance with B7, provided, however, that the goods have been duly appropriated to the contract, that is to say, clearly set aside or otherwise identified as the contract goods.

6. Division of costs

The buyer must pay

- all costs relating to the goods from the time they have passed the ship's rail at the named port of shipment; and
- any additional costs incurred, either because the vessel nominated by him fails to arrive on time, or is unable to take the goods, or closes for cargo earlier than the time notified in accordance with B7, or because the buyer has failed to give appropriate notice in accordance with B7, provided, however, that the goods have been duly appropriated to the contract, that is to say, clearly set aside or otherwise identified as the contract goods; and
- where applicable, all duties, taxes and other charges as well as the costs of carrying out customs formalities payable upon import of the goods and for their transit through any country.

7. Notice to the seller

The buyer must give the seller sufficient notice of the vessel name, loading point and required delivery time.

8. Proof of delivery, transport document or equivalent electronic message

The buyer must accept the proof of delivery in accordance with A8.

9. Inspection of goods

The buyer must pay the costs of pre-shipment inspection except when such inspection is mandated by the authorities of the country of export.

10. Other obligations

The seller must render the buyer at the latter's request, risk and expense, every assistance in obtaining any documents or equivalent electronic messages (other than those mentioned in A8) issued or transmitted in the country of shipment and/or of origin which the buyer may require for the import of the goods and, where necessary, for their transit through any country.

CIF COST, INSURANCE AND FREIGHT (. . . named port of destination)

"Cost, Insurance and Freight" means that the seller delivers when the goods pass the ship's rail in the port of shipment.

The seller must pay the costs and freight necessary to bring the goods to the named port of destination BUT the risk of loss of or damage to the goods, as well as any additional costs due to events occuring after the time of delivery, are transferred from the seller to the buyer. However, in CIF the seller also has to procure marine insurance against the buyer's risk of loss of or damage to the goods during the carriage.

Consequently, the seller contracts for insurance and pays the insurance premium. The

buyer should note that under the CIF term the seller is required to obtain insurance only on minimum cover. Should the buyer wish to have the protection of greater cover, he would either need to agree as much expressly with the seller or to make his own extra insurance arrangements.

The CIF term requires the seller to clear the goods for export.

This term can be used only for sea and inland waterway transport. If the parties do not intend to deliver the goods across the ship's rail, the ["Carriage and Insurance Paid to"] term[a] should be used.

A. THE SELLER'S OBLIGATIONS

1. Provision of goods in conformity with the contract

The seller must provide the goods and the commercial invoice, or its equivalent electronic message, in conformity with the contract of sale and any other evidence of conformity which may be required by the contract.

2. Licenses, authorizations and formalities

The seller must obtain at his own risk and expense any export license or other official authorization and carry out, where applicable, all customs formalities necessary for the export of the goods.

3. Contracts of carriage and insurance

a) Contract of carriage

The seller must contract on usual terms at his own expense for the carriage of the goods to the named port of destination by the usual route in a seagoing vessel (or inland waterway vessel as the case may be) of the type normally used for the transport of goods of the contract description.

b) Contract of insurance

The seller must obtain at his own expense cargo insurance as agreed in the contract, such that the buyer, or any other person having an insurable interest in the goods, shall be entitled to claim directly from the insurer and provide buyer with the insurance policy or other evidence of insurance cover.

The insurance shall be contracted with underwriters or an insurance company of good repute and, failing express agreement to the contrary, be in accordance with minimum cover of the Institute Cargo Clauses (Institute of London Underwriters) or any similar set of clauses. The duration of insurance cover shall be in accordance with B5 and B4. When required by the buyer, the seller shall provide at the buyer's expense war, strikes, riots and civil commotion risk insurances if procurable. The minimum insurance shall cover the price provided in the contract plus ten per cent (i.e., 110%) and shall be provided in the currency of the contract.

4. Delivery

The seller must deliver the goods on board the vessel at the port of shipment on the date or within the agreed period.

5. Transfer of risks

The seller must, subject to the provisions of B5, bear all risks of loss of or damage to the goods until such time as they have passed the ship's rail at the port of shipment.

6. Division of costs

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a. The "Carriage and Insurance Paid to" term (CIP) requires the seller to pay the freight for carriage of the goods to the named destination, with risk of loss, damage or additional costs passing to the buyer when the goods have been delivered to the carrier, and to procure cargo insurance against the buyer's risk of loss of or damage to the goods during carriage.

The seller must, subject to the provisions of B6, pay

- all costs relating to the goods until such time as they have been delivered in accordance with A4; and
- the freight and all other costs resulting from A3a), including the costs of loading the goods on board; and
- any charges for unloading at the agreed port of discharge which were for the seller's account under the contract of carriage; and
- where applicable, the costs of customs formalities necessary for export as well as all duties, taxes and other official charges payable upon export, and for their transit through any country if they were for the seller's account under the contract of carriage.

7. Notice to the buyer

The seller must give the buyer sufficient notice that the goods have been delivered in accordance with A4 as well as any other notice required in order to allow buyer to take measures which are normally necessary to enable him to take the goods.

8. Proof of delivery, transport document or equivalent electronic message

The seller must, at his own expense, provide the buyer without delay with the usual transport document for the agreed port of destination.

This document (for example, a negotiable bill of lading, a non-negotiable sea waybill, an inland waterway document) must cover the contract goods, be dated within the period agreed for shipment, enable the buyer to claim the goods from the carrier at destination and, unless otherwise agreed, enable the buyer to sell the goods in transit by the transfer of the document to a subsequent buyer (the negotiable bill of lading) or by notification to the carrier. . . .

Where the seller and the buyer have agreed to communicate electronically, the document referred to in the preceding paragraphs may be replaced by an equivalent electronic data interchange (EDI) message.

9. Checking - packaging - marking

The seller must pay the costs of those checking operations (such as checking quality, measuring, weighing, counting) which are necessary for the purpose of delivering the goods in accordance with A4.

The seller must provide at his own expense packaging (unless it is usual for the particular trade to ship the goods of the contract description unpacked) which is required for the transport of the goods arranged by him. Packaging is to be marked appropriately.

10. Other obligations

The seller must render the buyer at the latter's request, risk and expense, every assistance in obtaining any documents or equivalent electronic messages (other than those mentioned in A8) issued or transmitted in the country of shipment and/or of origin which the buyer may require for the import of the goods and, where necessary, for the transit through any country.

B. THE BUYER'S OBLIGATIONS

1. Payment of the price

The buyer must pay the price as provided in the contract of sale.

2. Licenses, authorizations and formalities

The buyer must obtain at his own risk and expense any import license or other official authorization and carry out, where applicable, all customs formalities for the import of the goods and for their transit through any country. . . .

4. Taking delivery

The buyer must accept delivery of the goods when they have been delivered in accordance with A4 and receive them from the carrier at the named port of destination.

5. Transfer of risks

The buyer must bear all risks of loss of or damage to the goods from the time they have passed the ship's rail at the port of shipment.

The buyer must, should he fail to give notice in accordance with B7, bear all risks of loss of or damage to the goods from the agreed date or the expiry date of the period fixed for shipment provided, however, that the goods have been duly appropriated to the contract, that is to say, clearly set aside or otherwise identified as the contract goods.

6. Division of costs

The buyer must, subject to the provisions of A3, pay

- all costs relating to the goods from the time they have been delivered in accordance with A4; and
- all costs and charges relating to the goods whilst in transit until their arrival at the port of destination, unless such costs and charges have been levied by regular shipping lines when contracting for carriage; and
- unloading costs including lighterage and wharfage charges, unless such costs and charges were for the seller's account under the contract of carriage; and
- all additional costs incurred if he fails to give notice in accordance with B7, for the goods from the agreed date or the expiry date of the period fixed for shipment provided, however, that the goods have been duly appropriated to the contract, that is to say, clearly set aside or otherwise identified as the contract goods; and
- where applicable, all duties, taxes, and other official charges as well as the costs of carrying out customs formalities payable upon import of the goods and, where necessary, for their transit through any country unless included within the cost of the contract of carriage.

7. Notice to the seller

The buyer must, whenever he is entitled to determine the time for shipping the goods and/or the port of destination, give the seller sufficient notice thereof.

8. Proof of delivery, transport document or equivalent electronic message

The buyer must accept the transport document in accordance with A8 if it is in conformity with the contract.

9. Inspection of goods

The buyer must pay the costs of pre-shipment inspection except when such inspection is mandated by the authorities of the country of export.

10. Other obligations

The buyer must pay all costs and charges incurred in obtaining the documents or equivalent electronic messages mentioned in A10 and reimburse those incurred by the seller in rendering his assistance in accordance therewith.

The buyer must provide the seller, upon request, with the necessary information for procuring insurance.

QUESTIONS

1. The Brazilian Coffee Institute exports 100 bags of green coffee to the Beta Corporation in New York for roasting and grinding in its U.S. facilities. The bags are shipped from Brazil, on June 1, 2001, on an FOB basis. On June 3, 2001, due to heavy seas, the ship sinks en route to the United States. Who bears the loss in this instance,

the Brazilian Coffee Institute or the Beta Corporation? What if the bags had been shipped CIF?

2. What if, due to leakage, water spoils the shipment of coffee, which arrives ruined in New York? What difference might this make in the outcome in an FOB shipment? A CIF shipment?

3. What if, following arrival of the coffee in New York (shipped FOB), the coffee is stolen off the deck of the vessel while it is anchored in the harbor? What if the coffee is stolen off the dock after it is unloaded? In either of these alternative situations, would a make a difference if the coffee had been shipped CIF?

b. The Bill of Lading

Under either technique of shipment, the seller (or his or her agent) will receive a *bill of lading* from the carrier. This bill is in the form of a contract between the shipper (the person who wants the goods moved) and the carrier (the firm that actually transports them) and serves the standard form contract functions of allocating the various risks of carriage. But it also serves a very important additional function, that of being a receipt that becomes a document of title for the goods, and is frequently negotiable. After the seller receives the bill of lading in return for the goods, it can then sign it over to the buyer and give the latter the right to obtain the goods from the carrier at the destination. The negotiation can be thought of as similar to the negotiation or endorsement of a check-only it transfers the right to receive goods from a carrier rather than that to receive money from a bank. Thus, in form, the buyer can now think of buying the bill of lading-and the buyer's bank can confidently make payment to the seller when the bill of lading is received, rather than having to deal in the goods themselves or wait until they are received at the dock.

Figure 2-1, *infra*, shows a contemporary international bill of lading (omitting the fine print on the reverse).

BERMAN AND KAUFMAN, THE LAW OF INTERNATIONAL COMMERCIAL TRANSACTIONS (*LEX MERCATORIA*)

19 Harv. Intl. L.J. 221, 237-243 (1978), *revised and republished*, 2 Emory J. Int'l Dispute Resolution 233 (1988)

The Documentary Character of an International Sale
Bills of Lading

Under the typical c.i.f. or other "shipment" contract, the seller is required to select a vessel, to secure the necessary shipping space, and to see to it that the goods are placed on board. At that point the seller normally receives from the carrier a bill of lading. This document has a threefold character: (1) it is the carrier's acknowledgement of receipt of the goods; (2) it embodies the terms of the contract of carriage; and (3) it is a document of title, that is, the person rightfully in possession of it is entitled to possess, use, and dispose of the goods represented by it.

Two kinds of bills of lading should be distinguished: the straight (nonnegotiable) bill and the order (negotiable) bill. A straight bill obliges the carrier to deliver the goods to the named consignee whether or not he surrenders the bill of lading. Transfer of a straight bill under the general principles of contract law gives the transferee no greater

rights than those of his transferor. A negotiable bill, on the other hand, conveys greater rights, which are generally defined in special legislation.

In the United States, the federal Bills of Lading Act of 1916 (Pomerene Act)[56] governs bills issued for shipments in interstate and foreign commerce which originate in the United States.[57] Bills of lading issued for shipments of goods to the United States from abroad would presumably be governed by foreign law. Under the Pomerene Act a negotiable bill of lading must be addressed "to the order of" the recipient or "to bearer" and is subject to transfer through due negotiation. The holder of a negotiable bill of lading, provided he has received it in good faith through due negotiation, has a claim to title and, upon surrender of the bill, to delivery of the goods from the carrier regardless of certain rights which the carrier or exporter may have against the person to whom the bill of lading was originally issued or against some intervening party. In technical terms the order bill of lading is a negotiable document of title which may be transferred free of personal defenses.[58] . . .

Payment Against Documents in a C.I.F. Contract . . .

The bill of lading makes the carrier liable for . . . loss or damage only under certain circumstances and only within certain financial limits.[61] Therefore, before an importer (or his bank) will pay for the goods, he (or it) will want to receive not only the bill of lading but also a policy or certificate of marine insurance naming the holder of the bill of lading as its beneficiary. He will also want an invoice as well as any other documents that may be required for exportation and importation, such as export license, import license, consular invoice, certificate of origin, and others. Under a typical c.i.f. contract, it is this entire package of documents that must be transferred by the seller to the buyer, or to the bank appointed by the buyer, before payment is made.[62] Indeed, the typical documentary transaction calls for multiple copies of the documents-the commercial invoice in triplicate, a "full set" of bills of lading (one to be sent by ocean mail, one by air, and perhaps one by land), and sometimes multiple copies of other documents as well.

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56. 49 U.S.C. §§81-124 (1970). The act covers both straight and negotiable bills of lading, but the provisions on straight bills generally follow the normal rules of contract law and assignment. *See* 49 U.S.C. §l 12 (1970).

57. 49 U.S.C. §81 (1970). The rights and obligations of carriers and shippers engaged in a foreign shipment which touches a port in the United States are also governed by the Carriage of Goods by Sea Act [COGSAI of 1936, 46 U.S.C. §§1300-1315 (1970). But COGSA deals mainly with the contract of carriage aspect of the bill of lading and not with its function as a document of title.

58. Federal Bills of Lading Act, 49 U.S.C. §§ l11, 117 (1970).

61. *See* 46 U.S.C. §§ 1302-1306 (1970).

62. U.C.C. §2-320(2) (1962 version). . . .

[INSERT 2-1 HERE]

FIGURE 2-1
An Intemational Bill of Lading
Reprinted with permission of International Chamber of Commerce

Payment under a c.i.f. contract is to be made against documents only, unless otherwise agreed. The Uniform Commercial Code expressly forbids the seller to tender the goods themselves instead of the documents.[63] The reason for this is that banks normally play an important role in financing documentary transactions in international trade, and a bank that pays money to an exporter on behalf of an importer is better able to protect its security interest if the exporter is not permitted to avoid the tender of documents. Otherwise, possibilities of fraud may arise. For example, the importer who receives the goods may mortgage them to another lender, free of the bank's lien, or the exporter may supply goods of lower quality and value than the contract requires. Without the disclosures provided by the documents, the bank will not be alerted to obtain the exporter's check to the importer for the difference in value or to take other measures to reduce its loan. Essentially, the requirement in a c.i.f. contract that documents be transferred meets the same need as the requirement in a face-to-face transaction-for example, the sale of an automobile-that title documents go to the lender before the product goes to the buyer.

The documentary aspect of the c.i.f. transaction leads to the substitution of documents for goods in so many respects that it may also lead to the conclusion that the substitution is intended to be complete. Indeed, in one case, a great English commercial judge, Lord Scrutton, suggested that many of the difficulties arising from c.i.f. contracts could be resolved if the c.i.f. sale were understood not as a sale of goods but as a sale of documents relating to the goods: "he [the buyer] buys the documents, not the goods."[64] This statement was sharply disputed in the same case by other English judges, who described the c.i.f. contract as "a contract for the sale of goods to be performed by the delivery of documents."[65] Yet in a later case, another English judge stated: "the obligation of the vendor is to deliver documents rather than goods-to transfer symbols rather than the physical property represented thereby."[66] To say that the contract is for the sale of documents, not of goods, may be only a convenient metaphor.[67] Certainly the documents presuppose the shipment of the goods to which they refer. Yet there is at least one situation in which the seller may perform his c.i.f. contract by tendering documents although the goods have not been shipped-namely, where the buyer agrees to accept a received-for-shipment bill of lading which states that the goods are in the custody of the shipowner and awaiting shipment on a vessel which may or may not be named. Moreover, it is well established that if, after shipment, the goods are lost at sea, the seller may tender shipping documents and demand payment, even where he knows at the time of the transfer that the goods have been lost.[68] This makes sense because the

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63. U.C.C. §2-320(4) (1962 version).

64. *Arnold Karberg & Co. v. Blythe, Green, Jourdain & Co.*, [1915] 2 K.B. 379, 388, *affirmed*, [1916] 1 K.B. 495 (C.A. 1915).

65. [1916] 1 K.B. at 510 (Bankes, L.J., dissenting); *id.* at 514 (Warrington, L.J., dissenting) (joining in the remarks of Bankes, L.J., as to the character of a c.i.f. contract).

66. *Manbre Saccharine Co. v. Corn Products Co.*, [1919] 1 K.B. 198, 203 (1918) (McCardie, J.).

67. In *Malmberg v. Evans & Co.*, [19241 30 Com. Cas. 107, 112, Scrutton, L.J., replied to the rebuke of Bankes and Warrington, note 65 *supra*, stating: "I need not discuss, what perhaps is a mere question of words, whether that sale is a sale of goods or of documents. One of the features of a sale c.i.f. is that, in the absence of special terms, the seller claims payment against presentation of shipping documents."

68. *Smith Co. v. Marano*, 267 Pa. 107, 110 A. 94 (1920); *Manbre Saccharine Co. v. Corn Products Co.*, [1919] 1 K.B. 198 (1918).

buyer has agreed to accept the risk of loss of the goods and is protected by insurance.[69]

QUESTIONS

1. It is natural to think of the bill of lading as a *receipt* that stands as a "proxy" for possession of the goods described in the document. We must emphasize, however, that the document is the *contract* between the shipper and the carrier, and its terms should therefore be considered with care. What problems might you expect in writing terms for a "through bill of lading," *e.g.*, one involving containerized goods, which is issued by an inland carrier (typically a railroad or trucking agency) to cover the entire voyage, including transshipment to a vessel, and perhaps carriage on another inland carrier from the ship's destination? What about use of computers rather than paper? Note the problems of allocating responsibilities for damages, and also the possible problems of complying with the applicable domestic laws of different nations through which the goods pass. *See* U.N. Convention on the Carriage of Goods by Sea (1978, entered into force for the United States, 1992); UNCTAD/ICC Rules for Multimodal Transport Documents; Jarvis (Chair), Panel Discussion, *Litigation with a Foreign Flavor: A Comparison of the Warsaw Convention and the Hamburg Rules*, 59 J. Air Law & Comm. 907 (1994); Ramberg, *The Vanishing Bill of Lading and the "Hamburg Rules Carrier*," 27 Am. J. Comp. L. 391 (1979); *Admiralty Law Institute Symposium: Terminal Operations and Multimodalism*, 64 Tulane L. Rev. 281 (1989).

2. What would you see as the central problems in a paperless, *i.e.* electronic, bill of lading? The *Comité Maritime International* has been developing a set of rules based on a public key/private key method of authentication. *See* R. Kelly. *The CMI Charts a Course on the Sea of Electronic Data Interchange: Rules for Electronic Bills of Lading*, 16 Tulane Maritime L.J. 349 (1992).

3. What would you anticipate as the contract complications for the shipper/seller of goods that are to be delivered by means of multimodal transport, with *separate* bills of lading issued for each leg of the trip? Based on the following case, what advice would you give to a shipper client in drafting future multimodal bills of lading? What advice would you give to a railroad or trucking client offered the inland transport leg by an international shipper?

JAMES N. KIRBY, PTY LTD. v. NORFOLK SOUTHERN RAILWAY CO.

300 F.3d 1300 (11th Cir. 2002)

CARNES, CIRCUIT JUDGE

This case, the facts of which began in Australia and ended in Alabama, is about Himalaya clauses, Clauses Paramount, COGSA, the package limitation defense, FBLs, FIATA, and the like. In short, it is a bill of lading case. The issue it presents us is whether a railroad's liability, if any, to a shipper for damage done to goods by the

69. It is not wholly accurate to state that even if the goods are lost the buyer has nonetheless realized the object of his purchase, for the loss may have resulted from causes not covered by the insurance; and even if the loss or damage is attributable to one covered by the policy, the buyer must bear the burdens and expense of recouping his loss and the risk that even after protracted litigation he may not in fact be effectively reimbursed.

derailment a train is limited by the "Himalaya clause" in either of two bills of lading that were issued for the transport of the goods.

A Himalaya clause is a clause in a bill of lading that extends the carrier's defenses and limitations of liability under the bill to the carrier's agents and subcontractors.[1] Both bills of lading in this case contained Himalaya clauses, although the text of each clause is different. The first bill of lading was issued to James N. Kirby Pty Ltd. (Kirby) by International Cargo Control Pty Ltd. (ICC), an Australian freight forwarder Kirby hired to arrange the shipment of the machinery, and the second bill of lading was issued to ICC by Hamburg Sud, the ocean shipping company ICC hired to perform the actual transport of the goods. Hamburg Sud's ship brought the machinery from its port of departure, Sydney, Australia, to its port of discharge, Savannah, Georgia, where it was placed on a train owned by Norfolk Southern Railway Co., which Hamburg Sud had sub-contracted to transport the machinery inland to its destination, Huntsville, Alabama. The wreck occurred while the train was en route to Huntsville from Savannah, and allegedly caused $1.5 million of damage to the machinery.

The district court decided that Norfolk Southern could limit its liability to Kirby on the basis of the Himalaya clause in the Hamburg Sud bill. We conclude, however, that the Hamburg Sud bill does not limit Norfolk Southern's liability to Kirby because Kirby was not bound by its terms. We further conclude that although the terms of the ICC bill do bind Kirby, that bill does not limit Norfolk Southern's liability because Norfolk Southern is not a clearly designated beneficiary of that bill's Himalaya clause. Therefore, because the district court erroneously concluded that Norfolk Southern should be able to limit its liability to Kirby, we reverse and remand.

I. BACKGROUND

Kirby, a company based in Sydney, Australia, sold ten containers of machinery to the General Motors plant in Huntsville, Alabama. To fulfill its obligation to deliver the machinery to Huntsville, Kirby entered into a contract of carriage with ICC, another Australian company. ICC was a "freight forwarder," a company that arranges for, coordinates, and facilitates cargo transport. To formalize the contract of carriage, ICC issued a bill of lading to Kirby (the ICC bill of lading) for the ten containers of machinery.

The ICC bill of lading embodies ICC's contractual obligation to Kirby to deliver the machinery from Sydney to Huntsville. It names Kirby as the consigner of the cargo, and ICC as the carrier. It designates Sydney as the port of loading, Savannah as the port of discharge, and Huntsville as the ultimate destination of the machinery. It contains a Clause Paramount that invokes the defenses and limitations of liability of the Carriage of Goods by Sea Act (COGSA), 46 U.S.C. §§ 1300-1315[,] to govern ICC's liability to Kirby for any damage done to the goods in the course of the carriage. Finally, it contains a Himalaya clause, a contractual clause that extends to the carrier's agents and contractors the carrier's own defenses and limitations of liability under the bill. *See Fireman's Fund Ins. Co. v. Tropical Shipping & Constr. Co.*, 254 F.3d 987, 993 n. 1 (11th Cir.2001). Specifically, the Himalaya clause in the ICC bill of lading extends the bill's limitations of ICC's liability to "any servant, agent or other person including any independent contractors whose services have been used to perform the contract."

Having been hired by Kirby, ICC then hired Hamburg Sud, a German ocean shipping

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1. Himalaya clauses take their name from an English case which involved a vessel called the HIMALAYA. *Certain Underwriters at Lloyds' v. Barber Blue Sea Line*, 675 F.2d 266, 269 n. 5 (11th Cir.1982).

company, to transport the machinery from Sydney to Huntsville. Hamburg Sud issued its own bill of lading (the "Hamburg Sud bill") to ICC. On the Hamburg Sud bill, ICC was listed as the shipper, and Hamburg Sud as the carrier. Like the ICC bill, the Hamburg Sud bill named Sydney as the port of loading, Savannah as the port of discharge, and Huntsville as the destination. The Hamburg Sud bill contained its own Clause Paramount, and its own Himalaya clause that extended the bill's limitations on Hamburg Sud's liability to "all agents, servants, employees, representatives, all participating (including inland) carriers and all stevedores, terminal operators, warehousemen, crane operators, watchmen, carpenters, ship cleaners, surveyors and all independent contractors whatsoever."

A Hamburg Sud ship carried the machinery on the ocean leg of the journey, from Sydney to Savannah. Once in Savannah, inland transport to Huntsville was taken on by Norfolk Southern, which had been hired by Hamburg Sud through Columbus Line USA, Hamburg Sud's American subsidiary. Norfolk Southern did not issue its own bill of lading to Columbus Line, but instead acted under the Hamburg Sud bill. The train carrying the containers derailed while en route from Savannah to Huntsville, and allegedly $1.5 million dollars of damage was done to the machinery.

After the train wreck, Kirby sued Norfolk Southern to recover for the damages caused to the machinery by the derailment. Kirby's claims included negligence and breach of contract, among others. Norfolk Southern denied that it was liable, but also filed a motion for partial summary judgment arguing that its liability, if any, was limited by the Himalaya clause in the Hamburg Sud bill of lading.

. . . Here, as is often the case, both bills invoked the Carriage of Goods by Sea Act (COGSA), meaning that the carrier's defenses and limitations under each bill-and, by extension, the defenses and limitations of any party covered by each bill's Himalaya clause included those provided to carriers by COGSA.[5] One COGSA defense available to a carrier is the "package limitation," which limits the carrier's liability for damage to goods to $500 per package (when the goods are shipped in packages). 46 U.S.C. app. § 1304(5). By invoking COGSA in the Clause Paramount, each bill incorporated COGSA's package limitation as a limit on the carrier's liability. In its summary judgment motion Norfolk Southern claimed that it was entitled, via the Himalaya clause, to claim the package limitation, and thus limit its liability to $5,000–$500 for each of Kirby's ten containers.[6]

. . . The district court . . . designated its order granting partial summary judgment [to Norfolk Southern] as appropriate for interlocutory appeal pursuant to 28 U.S.C. § 1292(b), and we granted permission to appeal on the issue of whether the bills of lading limit Norfolk Southern's liability.

II. DISCUSSION

We first consider whether the district court was right to decide that the Himalaya clause in the Hamburg Sud bill limited Norfolk Southern's liability to Kirby. Because we conclude that it was not right in that regard, we next consider whether Norfolk Southern's liability is limited by the Himalaya clause in the other bill of lading, the ICC

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5. COGSA applies of its own force from "tackle to tackle," that is from the time goods are loaded onto the ship to the time they are discharged from it. *See Mannesman Demag Corp. v. M/V CONCERT EXPRESS*, 225 F.3d 587, 589 (5th Cir.2000). The Clause Paramount extends the application of COGSA's liability rules beyond the tackles, just as the Himalaya clause extends the application of those rules to parties other than the carrier.

6. Whether a container is a COGSA "package" is a topic of frequent dispute. *See, e.g., Tropical Shipping*, 254 F.3d at 997. The issue is not, however, material to disposition of this appeal.

bill. We conclude that it is not so limited. The result of our conclusions that neither bill of lading limits Norfolk Southern's liability to Kirby is that we reverse the district court's grant of partial summary judgment to Norfolk Southern.

A. THE HAMBURG SUD BILL

The Hamburg Sud bill was issued by Hamburg Sud, the ocean shipping company, to ICC, the freight forwarder which had been engaged by Kirby. The Himalaya clause in the Hamburg Sud bill can limit Norfolk Southern's liability to Kirby only if Kirby is bound by the terms of that bill. Yet ICC, not Kirby, hired Hamburg Sud, and ICC, not Kirby, is named on the bill as the shipper of the goods, which means that Kirby did not itself agree to the terms of the bill. If, however, ICC had been acting as Kirby's agent when it entered the shipping contract with Hamburg Sud, then ICC had authority to and did bind Kirby to the terms of the bill, including its package limitation and its Himalaya clause. *See, e.g., Great N. Ry. Co. v. O'Connor*, 232 U.S. 508, 513-14 (1914) (holding that a plaintiff who used a freight forwarder to arrange a shipment of goods was bound by limitations of liability in the contracts the freight forwarder made with carriers on the plaintiff's behalf). Therefore, Norfolk Southern can limit its liability to Kirby only if ICC was acting as Kirby's agent when it received Hamburg Sud's bill. Whether it was acting as Kirby's agent at that time is, then, the pivotal question.

ICC's status as a freight forwarder is not itself dispositive of the question, because freight forwarders "may act as agents or as principals, depending on the facts." Stephen G. Wood, *Multimodal Transportation: an American Perspective on Carrier Liability and Bill of Lading Issues*, 46 Am. J. Comp. L. 403, 413 (1998). A freight forwarder acts as an agent when its role is merely to arrange a contract between the cargo owner and the ocean carrier. The ocean carrier issues a bill of lading directly to the cargo owner, who is listed as the shipper on the bill, and the cargo owner pays the ocean carrier, not the freight forwarder, for the carriage. A freight forwarder acts as a principal when it takes on the role of carrier itself, and issues its own bill to the cargo owner listing the cargo owner as the shipper and itself as the carrier. In this latter scenario, the cargo owner pays the forwarder, not the ocean carrier. The forwarder then subcontracts out to an ocean carrier its responsibility under its bill to carry the goods. The ocean carrier issues to the forwarder a second bill of lading that lists the forwarder as the shipper, that is, as a principal.

In this case, ICC was acting as a carrier–a principal–and not as Kirby's agent. This is evident, first, from the structure of the transaction. There were two bills of lading. If ICC had been acting as Kirby's agent, there would have been only one bill of lading, issued by Hamburg Sud to Kirby and listing Kirby as the shipper. Instead, ICC issued a bill to Kirby, and then ICC in turn was issued a bill by Hamburg Sud. The Hamburg Sud bill listed ICC, not Kirby, as the shipper, thereby evidencing that Hamburg Sud was contracting with ICC as principal and not as agent for Kirby.

That ICC was not acting as Kirby's agent is further evident from the language of the ICC bill. The ICC bill expressly states that ICC was undertaking "to *perform* ... the entire transport," or "*in [its] own name* to procure the performance of the entire transport." [Emphasis added by the court.] This plain language shows that ICC and Kirby clearly intended that ICC would act as a principal in any subsequent contracts it entered into for the transport of the machinery. In the bill ICC assumes responsibility "for the acts or omissions of its servants or agents." Again, this language indicates that ICC was not acting as Kirby's agent, because if ICC were acting as Kirby's agent it would not be liable for the acts of other agents it hired on behalf of Kirby–they would be Kirby's agents, not ICC's.

The form of the ICC bill also shows ICC was a principal, not Kirby's agent. The bill ICC issued to Kirby was a standard form bill known in the industry as a FBL, which is short for "FIATA Multimodal Transport Bill of Lading."[8] The fact that the bill was an FBL is evident on the face of the bill, whose upper right hand corner bears a logo with the words "FBL" and "FIATA Multimodal Transport Bill of Lading." Commentary from the drafters of the FBL indicates that, when the FBL form is used, the freight forwarder assumes the role of carrier and therefore becomes a principal. *See* Jan Ramberg, *The Law of Freight Forwarding and the 1992 FIATA Multimodal Transport Bill of Lading* 7 (1993) (chair of the FIATA committee that initially drafted the FBL explaining that "[b]y use of FBL the freight forwarder progresses from the legal jungle and clearly establishes himself as a carrier with carrier liability"). While the intent of the drafters of the FBL form does not alone determine the nature of the relationship between Kirby and ICC, that intent, together with the fact that ICC and Kirby chose to use the FBL form, buttresses our conclusion that in receiving ICC's bill Kirby did not engage ICC as its agent, but instead hired ICC as a principal carrier to perform the transport, which ICC in turn sub-contracted to Hamburg Sud.

The Hamburg Sud bill reinforces the conclusion that ICC was acting as principal, and not as Kirby's agent, when it engaged Hamburg Sud. That bill lists ICC, not Kirby, as the party with whom Hamburg Sud was contracting. If ICC had merely been acting as Kirby's agent, arranging a contract between Kirby and an ocean carrier, we would expect the contract with the ocean carrier to reflect as much by indicating that Kirby was a party to the transaction. Yet Kirby's name does not appear on the Hamburg Sud bill.

Finally, our own case law suggests that a freight forwarder should not automatically be taken to be the agent of the party who hires it to facilitate the shipment of goods. In *Naviera Neptuno S.A. v. All Int'l Freight Forwarders, Inc.* 709 F.2d 663, 665 (11 th Cir.1983), we reviewed a district court's finding that a freight forwarder was not the agent of the party on whose behalf it had arranged the transport of cargo. Based on its reading of case law, the district court had stated a rule that "absent special particular arrangements between a shipper and its freight forwarder, which arrangements would manifest the requisite exclusivity and control incident to a principal/agent relationship, a freight forwarder is considered as an independent contractor." *Id.* Applying that rule, the district court found that the freight forwarder had not been the agent of the owner of the goods. *Id.* We upheld that finding. *Id.* Implicit in our doing so was approval of the rule applied by the district court. In the present case, there were no "special particular arrangements" between Kirby and ICC indicating "exclusivity and control" characteristic of an agency relationship. Instead, Kirby and ICC conducted their transaction on the basis of a form bill, a form bill which, as we have noted, was specifically intended to clearly establish that the freight forwarder, ICC, was *not* the agent of the shipper, Kirby.

Therefore, as the parties intended, and as our case law suggests, when ICC issued its bill to Kirby, ICC did not become Kirby's agent and so did not act as Kirby's agent when it received the second bill of lading from Hamburg Sud.[9] This means that Kirby is not

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8. FIATA is the International Federation of Freight Forwarders Associations, a non-governmental association that represents the freight forwarding industry. "Multimodal" means transport by more than one mode of transportation, *e.g.*, by both ship and rail.

9. Norfolk Southern's main argument to the contrary is that, even though the parties did not intend for ICC to act as Kirby's agent, ICC must have been Kirby's agent because ICC was barred from acting as a carrier (and thus as a principal) by federal statute. Norfolk Southern argues that, if ICC was a carrier, it must have been an "ocean transportation intermediary," and as such was required by 46 U.S.C. app. § 1718(a) to have a license from the Federal Maritime Commission. Yet, according to Norfolk Southern, ICC did not have a license.

bound by the Himalaya clause in the Hamburg Sud bill, and that the district court erred in deciding that Norfolk Southern could limit its liability to Kirby based on the Hamburg Sud bill of lading.

B. THE ICC BILL

The ICC bill was issued by ICC to Kirby. Because Kirby was a party to the ICC bill it was clearly bound by that bill's terms, including its Himalaya clause. Thus any beneficiary of that Himalaya clause would be entitled to use it to limit its liability to Kirby. Norfolk Southern, however, is not a beneficiary of the Himalaya clause in the ICC bill, because the language of the clause does not specifically identify Norfolk Southern as a member of a well-defined class of its beneficiaries, as is required by the case law.

The roots of that requirement lie in the seminal American case on Himalaya clauses, *Robert C. Herd & Co. v. Krawill Mach. Corp.*, 359 U.S. 297 (1958). In *Herd,* the Supreme Court refused to extend a bill of lading's liability limitations to a stevedore, because the bill only mentioned the carrier as the beneficiary of those limitations. *Id.* at 302. The *Herd* Court, however, left open the possibility that a clause in a bill of lading could limit the liability of parties hired by the carrier, if drafted with sufficient clarity to specifically identify those parties. *Id.* Subsequent cases made that possibility a reality. Today Himalaya clauses are standard fare in bills of lading. However, courts addressing the enforceability of Himalaya clauses are constrained by the *Herd* Court's admonition that "contracts purporting to grant . . . limitation of liability must be strictly construed and limited to their intended beneficiaries." *Herd,* 359 U.S. at 305.

In this Circuit and its predecessor, Himalaya clauses have been enforced since soon after *Herd.* To temper the enforceability of Himalaya clauses with the principle that those clauses must be narrowly construed and limited to their intended beneficiaries, this Court has developed a "clarity of language" test for determining whether and for whom a Himalaya clause effectively limits liability. *See, e.g. Generali v. D'Amico,* 766 F.2d 485, 488 (11th Cir.1985); *Certain Underwriters at Lloyds v. Barber Blue Sea Line,* 675 F.2d 266, 270 (11th Cir.1982). Under our clarity of language test, we will enforce a Himalaya clause only if it is drafted with "language expressing a clear intent to extend the benefits to a well-defined class of readily identifiable persons," and we will allow the clause to be enforced only by members of that well-defined class. *Hale Container Line, Inc. v. Houston Sea Packing Co.*, 137 F.3d 1455, 1465 (11th Cir.1998).

The Himalaya clause in the ICC bill extends ICC's limitations on liability under the bill to "any servant, agent, or other person including any independent contractors whose services have been used in order to perform the contract." The question is whether this language is clear enough to "extend the benefits to a well-defined class of readily identifiable persons" that includes Norfolk Southern, the inland carrier. "Other person," as a category, is too vague to define a clearly identifiable class of persons, and so it fails

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This argument fails for a number of reasons. First, the licensing requirement Norfolk Southern invokes was not in force at the time that the ICC and Hamburg Sud bills of lading were issued for the transport of Kirby's cargo. The licensing requirement for "ocean transport intermediaries" came into effect in 1999, but the ICC-Kirby transaction occurred in 1997. *Compare* Ocean Shipping Reform Act of 1998, §§ 2, 116, Pub.L. No. 105-258, 112 Stat.1902, 1912 (amending § 1718(a) to require licenses for ocean transport intermediaries); *with* 46 U.S.C. app § 1718(a) (1994) (statute in force at time of Kirby-ICC transaction). Second, even if that statutory requirement had been in force at the time of the Kirby-ICC transaction, it applies only to a "person in the United States," which ICC, an Australian company doing business in Australia, was not. 46 U.S.C. app. § 1718(a). Third, there was no evidence in the summary judgment record that ICC had not registered with the F.M.C., a point on which Norfolk Southern, as the movant, had the burden of proof. Finally, Norfolk Southern has not convinced us that, even if ICC had been required to have a license to act as a carrier, its failure to have one would work to Kirby's detriment by rendering Kirby bound to the terms of a contract entered into by a party it had never made its agent.

to satisfy the clarity of language requirement. *Cf. Rupp v. Int'l Terminal Operating Co.*, 479 F.2d 674, 676 (2d Cir.1973) (finding phrase "all persons rendering services in connection with this contract" overbroad and therefore ineffective). This leaves, then, a Himalaya clause that extends to "any servant, agent, or .... any independent contractors."

We have previously stated that "[w]hen a bill refers to a class of persons such as agents and independent contractors, it is clear that the contract includes all those persons engaged by the carrier to perform the functions and duties of the carrier within the scope of the carriage contract. No further degree of clarity is necessary." *Certain Underwriters*, 675 F.2d at 270. Thus, for example, it is not necessary to enumerate specific categories of agents or independent contractors, such as "stevedore," "terminal operator," and the like. *Id.*

As to the ICC bill, however, Norfolk Southern was not "engaged by the carrier," ICC. Instead, Norfolk Southern was engaged by Hamburg Sud, who in turn had been engaged by ICC, the carrier. Norfolk Southern was a sub-sub-contractor, rather than a party directly "engaged by the carrier," and so it is not "clear that the contract includes" Norfolk Southern in the Himalaya clause. *Id.* If Kirby and ICC had intended for the protections of the ICC bill to extend to sub-sub-contractors, they could have said so. *See, e.g., Uncle Ben's v. Hapag-Lloyd Aktiengesellschaft*, 855 F.2d 215, 218 n. 2 (5th Cir.1988) (interpreting a Himalaya clause "for the benefit of the servants, employees and agents of the carrier as well as of such independent contractors *(including their servants, employees and agents*) whose services the carrier from time to time may engage ...") (emphasis added); *Gebr. Bellmer KG v. Terminal Serv. Houston, Inc.*, 711 F.2d 622, 625 (5th Cir.1983) (same language).

We recognize that the Ninth Circuit has arguably taken a different view. *Akiyama Corp. of Am. v. M.V. Hanjin Marseilles*, 162 F.3d 571, 574 (9th Cir.1998) (rejecting the argument that privity of contract is required in order to benefit from a Himalaya Clause, and focusing instead on comparing "the nature of the services performed [by the defendant who seeks to invoke the clause] compared to the carrier's responsibility under the carriage contract" (internal quotations omitted)).[10] In this Circuit, however, *Certain Underwriters* ' limitation of Himalaya clause protections to those parties "engaged by the carrier," together with the *Herd* principle of narrow construction, mean that the law requires privity between the carrier and the party seeking shelter in the Himalaya clause.[11]

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10. We also acknowledge that we have previously spoken approvingly of the Ninth Circuit's comparison-of-services rule. In *Hale*, we laid out out a two prong test for use in order "[t]o determine whether a party is an independent contractor referenced in a Himalaya clause." 137 F.3d at 1465-1466. Specifically, we said that "a court should (1) compare the nature of the services provided by the party with the carrier's responsibilities under the bill of lading or contract of carriage, and (2) consider whether the independent contractor's duty had been fulfilled at the time when the liability was incurred." *Id.* The first prong of that test is taken from the law of the Ninth Circuit, specifically from *Taisho Marine & Fire Ins. Co. v. Vessel Gladiolus*, 762 F.2d 1364 (9th Cir.1985), which is the same case from which *Akiyama* derived its rule. *Akiyama*, 162 F.3d at 574. In *Hale* we did not, however, affirm this test to the exclusion of a privity requirement. To the contrary, the very ground on which we denied the defendant the protection of the Himalaya clause in *Hale* was exactly that "Houston [the defendant] was neither an agent nor independent contractor of Project Logistics [the carrier] .... was not directly employed by Project Logistics, did not receive payment for its services from Project Logistics, had no contractual relationship with Project Logistics, and was not rendered an agent by Project Logistics." *Id.* at 1466. That is, in *Hale* we concluded that the defendant was not entitled to the benefit of the Himalaya clause specifically because he lacked privity (whether by contract, agency, or employment) with the carrier. Thus the result in *Hale* supports our conclusion in this case.

11. Privity is required where, as here, and as in *Certain Underwriters*, the category term being interpreted in the clause is relational, such as "agent," "servant," or "independent contractor." Where, on the other hand, the term is descriptive, such as "stevedore," "terminal operator," etc., privity of contract is not required. Indeed, the result, though not the language, of *Akiyama* conforms to this rule. In *Akiyama* the two parties were allowed to invoke the Himalaya clause. The first was a

In addition to not having been "engaged by the carrier," Norfolk Southern, unlike any other defendant that we have allowed to claim the benefit of a Himalaya clause, is an inland carrier. In all of our prior Himalaya clause cases, the defendant invoking the Himalaya clause has been a stevedore or other provider of port services. *See, e.g., Fireman's Fund Ins. Co. v. Tropical Shipping and Const. Co.*, 254 F.3d 987, 992 (11th Cir.2001) (stevedore); *Hiram Walker & Sons, Inc. v. Kirk Line*, 877 F.2d 1508, 1510 (11th Cir.1989) (stevedore); *Certain Underwriters*, 675 F.2d at 263 (stevedore and terminal operator). Thus the question of whether and when an inland carrier can claim the benefit of a Himalaya clause is, in this Circuit, still an open one. Other courts that have addressed this issue have reached a variety of results. Almost every court that has extended the protections of a Himalaya clause to an inland carrier has done so in a case where the language of the clause specifically referenced inland carriers. *See, e.g., Canon USA, Inc. v. Norfolk Southern Ry. Co.*, 936 F.Supp. 968, 971-72 (N.D.Ga. 1996); *Tokio Marine & Fire Ins. Co. v. Hyundai Merchant Marine Co.*, 717 F.Supp. 1307, 1309 (N.D.Ill.1989); *but see Taisho Marine and Fire Ins. Co. v. Maersk Line*, 796 F.Supp. 336, 339-40 (N.D.Ill.1992) (holding that a rail carrier was covered by a through bill's Himalaya clause that referred only to "subcontractors"). Further, many courts have refused to extend the coverage of a Himalaya clause to an inland carrier when the clause or the bill did not refer to inland transportation. *See, e.g., Caterpillar Overseas, S.A. v. Marine Transport, Inc.*, 900 F.2d 714, 726 (4th Cir.1990) (refusing to extend the protections of a Himalaya clause to a trucker because "[t]ransporting cargo down a group of public highways for a stretch of miles . . . is not a normal maritime operation"); *see also Lucky-Goldstar Int'l, Inc. v. S.S. California Mercury*, 750 F.Supp. 141 (S.D.N.Y.1990). Thus the cases seem to support the principle that a special degree of linguistic specificity is required to extend the benefits of a Himalaya clause to an inland carrier.

This principle makes sense in light of the origins and purpose of Himalaya clauses. Himalaya clauses originally were aimed more at extending COGSA protections to additional parties who handle cargo in and around a port than at extending the reach of those protections inland. That is why most of our cases concerning Himalaya clauses have involved as the defendants stevedores, terminal operators, and other similar parties whose work is done at or close to the point where the cargo is unloaded from the ship. We should be cautious about extending the reach of a Himalaya clause, and with it the reach of COGSA, inland.

We observe that caution in this case even though the bill, unlike bills we have considered in our previous Himalaya clause cases, was a "through bill," that is, a bill which provided for transport to an inland destination rather than merely to the port of discharge. *See Tokio Marine*, 717 F.Supp. at 1309 (defining through bill); *cf. Caterpillar*, 900 F.2d at 726 (declining, where the bill of lading only provided for ocean transport, to afford a trucker a Himalaya clause's protection of "independent contractors" because trucking is not a "maritime service"). The ICC bill identified Huntsville as the

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terminal operator, who did have contractual privity with the carrier, and was held to be covered by the relational term "independent contractor" in the clause. *Akiyama*, 162 F.3d at 574. The second was a stevedore, who contracted with the terminal operator and thus did not have direct contractual privity with the carrier, but was held to be covered by the descriptive term "stevedore" in the clause. *Id.* We also note that, while the dicta in *Akiyama* says a party seeking to invoke the Himalaya clause need not be in privity with the carrier, the reasoning of another, earlier Ninth Circuit case implicitly contradicts that dicta. *Mori Seiki USA, Inc. v. M/V Alligator Triumph*, 990 F.2d 444, 450-51 (9th Cir.1993) (allowing a stevedore to claim the benefit of a Himalaya clause only after concluding that the party with whom the stevedore contracted, the seaport operator, had acted as the carrier's agent in hiring the stevedore, thereby putting the stevedore in privity with the carrier).

point of delivery, which clearly indicates that the bill envisioned land transportation as being necessary to the completion of the contract. This does not mean, however, that the bill also envisioned that the liability regime for the inland leg of the journey would be provided by COGSA via the Himalaya clause. *But see Taisho Marine,* 796 F.Supp. at 340 (relying on the fact that the bill was a through bill in holding that a rail carrier was covered by the Himalaya clause's reference to "subcontractors").

The intent of the drafters of the form bill used between ICC and Kirby reinforces this observation. The FBL form was drafted based on a "network" approach to carrier liability. *See, e.g.*, Ramberg, *supra* at 25, 30-35, 37, 41-42, 65. The network approach envisions that each leg of a journey should be subject to the liability rules governing the mode of transport for that leg. *Id.* at 24. So, for example, losses on the sea leg would be governed by the rules applicable to the carriage of goods by sea, and losses on the rail leg would be subject to the liability regime applicable to railroads. Because the FBL was drafted with this "network" liability system in mind, its Himalaya clause was not designed to extend the liability regime for sea carriers–COGSA–to inland carriers, who instead would be covered by the different liability scheme applicable to rail carriers. The FBL's Himalaya clause is only meant to extend the carrier's protections to parties who are, so to speak, between liability regimes, at the fringes of the sea regime–stevedores, terminal operators, and the like. Therefore, Norfolk Southern, as an inland rail carrier, should not be allowed to invoke the Himalaya Clause in the ICC FBL to its benefit.

This is not to say that a Himalaya clause can never readily identify a well-defined class of persons that includes inland carriers like Norfolk Southern. However, if the Himalaya clause is to extend inland, it must say so with specificity, as, for example, did the Himalaya Clause in the Hamburg Sud bill when it clearly identified as among its beneficiaries "all participating (*including inland*) carriers." (emphasis added). *Cf., e.g. Lucky-Goldstar,* 750 F.Supp. at 145 ("If the parties . . . had intended to include [the railroad] among those protected, little effort would have been required for them to have added to [the Himalaya] clause the term 'inland carriers,' for example."); *Canon USA,* 936 F.Supp. at 973 ("road and rail transport operators"); *Toshiba Int'l Corp. v. M/V Sea-Land Exp.,* 841 F.Supp. 123, 128 (S.D.N.Y.1994) ("participating land carrier"). Requiring that the clause mention inland transport better satisfies our clarity of language requirement and serve its progenitor, *Herd* 's principle that liability limitations in bills of lading must be narrowly construed.

We therefore hold that the language of the Himalaya clause in the ICC bill, which names as its beneficiary "any servant, agent, or other person including any independent contractors whose services have been used in order to perform the contract," does not clearly identify Norfolk Southern, as a sub-sub-contractor of the carrier and an inland carrier, as a member of the "well-defined class of readily identifiable persons" entitled to claim the benefits of the clause. *Hale,* 137 F.3d at 1465. . . .

SILER, CIRCUIT JUDGE, dissenting:

I respectfully dissent from the majority decision. First, I disagree with the majority's conclusion that ICC was acting as a principal, not as Kirby's agent. As the majority states, ICC was a freight forwarder. Although a freight forwarder can be a principal, in this case it was acting as an agent for Kirby. The bill of lading between Kirby and ICC put Kirby on notice that ICC would have to employ other entities to transport the freight. I do not see any significance in having two bills of lading rather than one, which, the majority concludes, is evidence that ICC was not Kirby's agent. There is nothing in the

record which indicated that Kirby expected ICC to ship the goods other than by contracting it with another carrier. When Kirby entered into a written contract with ICC to make arrangements for the transportation of the shipment, it declined the opportunity to obtain full liability coverage via its contract. Instead, COGSA through the Clause Paramount limited liability of the carrier.

As the majority states, Kirby was bound by the terms of the bill of lading between it and ICC. That included the Himalaya Clause. Thus, that would include a limitation of liability for Hamburg Sud. I also think that Norfolk Southern was a beneficiary of the Himalaya Clause in the Kirby/ICC bill of lading. Clearly, the bill does not include the name "Norfolk Southern," nor does it say that it includes any inland carrier. Nevertheless, it includes "independent contractors." When the bill of lading between Kirby and ICC was issued, Kirby knew that an inland carrier would have to be used, because of the destination being Huntsville, Alabama. It also knew that it had agreed to a limitation of liability for the carrier. As the majority states, Kirby and ICC could have used clearer language in the bill to include any inland carriers, but that does not mean that the failure to include them specifically precludes the application of a Himalaya Clause. *See Certain Underwriters v. Barber Blue Sea Line*, 675 F.2d 266, 270 (11th Cir.1982) ("The 'clarity of language requirement,' [as stated in *Robert C. Herd & Co. v. Krawill Machinery Corp.*, 359 U.S. 297, 305 (1959)], does not mean, however, that COGSA benefits extend only to parties specifically enumerated in the bill of lading. It is sufficient that the terms express a clear intent to extend benefits to well-defined class of readily identifiable persons.") I would follow the decision in *Akiyama Corp. v. M.V. Hanjin Marseilles*, 162 F.3d 571, 574 (9th Cir.1998), which focused upon " the nature of the services performed compared to the carrier's responsibility under the carriage contract." I find no inconsistency in that decision with our decision in *Certain Underwriters*.

I also agree with the district court that Kirby was bound by the ICC/Hamburg Sud bill of lading, as it was a "through bill" which covered the entire transportation from Australia to Alabama. The ICC/Hamburg Sud bill of lading expressly included inland carriers. Therefore, the Himalaya Clause extended COGSA protection to Norfolk Southern. *See Taisho Marine & Fire Ins. Co. v. Maersk Line, Inc.*, 796 F.Supp. 336, 339-40 (N.D.Ill.1992); *Tokio Marine & Fire Ins. Co. v. Hyundai Merchant Marine Co.*, 717 F.Supp. 1307, 1309 (N.D.Ill.1989).

When Kirby initially engaged ICC, it accepted the risk and agreed to the limitation of liability on the part of ICC and all of its sub-contractors. Its insurer seeks a windfall by claiming no privity of contract. Kirby knew from the start that the ultimate destination would have to be through an inland carrier, so it should not be able to prevail on the technicality of its lack of privity of contract. Therefore, I would affirm the decision of the district court.

c. The Letter of Credit

By the use of the bill of lading, the buyer can help protect itself against the risk that no goods were shipped. In essence, the shipping company–which is likely to be a plausible defendant in any jurisdiction that it serves–is relied upon for the accuracy of a statement that the goods really were loaded on board. Although that statement usually describes the goods in very general terms, or even uses language like "boxes said to contain," it helps resolve the buyer's central risk that no goods were shipped. It does not, however, solve the seller's central problem-that of being sure to be paid, a problem solved by the letter of credit procedure.

A commercial or documentary letter of credit (L/C) is the commitment of the *issuing bank* that it will make payment to the L/C *beneficiary* on drafts drawn on the L/C under circumstances agreed upon between the parties and specified in the L/C. The customer of the bank who opens the L/C, known as the *account party*, is usually the buyer of goods. The L/C beneficiary is usually the seller of those goods, or a bank specified by the seller. The typical condition under which the issuing bank will make payment is the presentation to issuing bank of a draft (a procedure to be discussed in § A.1.d, *infra*) and other specified documents, such as the bill of lading for the goods sold and shipped, or other evidences of title, as well as insurance certificates, customs documents, and any other documents specified by the parties in their negotiations.

Often another bank, known as the *confirming bank*, is used to "confirm" the L/C, which means that it takes on the obligation to make payment to the beneficiary under the L/C, with subsequent presentation of demand to the issuing bank for reimbursement. A confirming bank may be used where the issuing bank is unknown to the beneficiary/seller, or where it is not convenient for the beneficiary to deal directly with an issuing bank in the buyer's home country.

A confirming bank should not be confused with an *advising bank*, which merely undertakes to inform the beneficiary/seller that an issuing bank has established an L/C in seller's favor. An advising bank does not undertake any obligation itself to make payment under the L/C.

Although we have not yet discussed drafts, it is still possible to construct a simple case to show how the L/C and bill of lading concepts can be combined to protect the two parties against the most serious risks-that no goods were shipped or that no payment will be made. After entering a contract for sale of the goods, the buyer/importer would ask its bank to issue an L/C naming the seller/exporter as beneficiary, and promising to pay when a bill of lading for the goods is presented. The bank will send this letter to the seller/exporter, thus giving the seller enough confidence of payment to ship the goods. When the seller does so, it will receive a bill of lading in return, will negotiate the bill to the order of importer, and airmail it to the importer's bank. On seeing that the documents are correct, the bank will pay the exporter and give the documents to the importer, who can meet the ship and pick up the goods with them.

Only in minor detail is the real world more complicated. The beneficiary may bring its draft, the bill of lading and other required documentation to its own bank for transmission to the issuing bank, either directly or through intermediary banks which may be advising or confirming banks. The L/C itself, and the rights and responsibilities of the parties and various banks involved in the transaction, are governed by a combination of domestic law (particularly article 5 of the Uniform Commercial Code in the United States), and of international principles stated in the Uniform Customs and Practice for Documentary Credits (UCP),[1] and there are technical surprises in this law. The most important is that a credit is revocable unless actually labeled "Irrevocable."

Under current practice, the letter itself is quite simple, as shown in Figure 2-2. Under appropriate circumstances, it may, of course, be transmitted in electronic form rather

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1. The UCP consists of rules negotiated by the International Chamber of Commerce and are typically referenced in a letter of credit, thus becoming part of the terms. The UCP rules are regularly updated, most recently on 1 January 1994; the current version is called UCP 500. See C. Del Busto, ed., ICC Guide to Documentary Credit Operations (1994); E. Ellinger, *The Uniform Customs and Practice for Documentary Credits -- The 1993 Revision*, 1994 Lloyd's Maritime & Comp. L.Q. 377; R. Rendell, *New ICC Rules Impact Letters of Credit*, 22 Int'l Fin. L. Rev. 28 (1994); J. Byrne, *Fundamental Issues in the Unification and Harmonization of Letter of Credit Law*, 37 Loyala L. Rev. 1 (1991).

than paper form. Electronic transmittal in L/C practice was facilitated by the 1995 revision of Article 5 approved by the National Conference of Commissioners on Uniform State Laws and the American Law Institute. When the original Article 5 was drafted, it was written with paper transactions in mind, and before many innovations in letters of credit. In current practice, electronic and other media are used extensively. Indeed, changes in usage, practice, and participants have been significant and pervasive, and the revised Article 5 sought to take these changes into account.

At a very basic level, some of the technical terminology of Article 5 has been revised.[2] The advising bank is now called the *adviser*;[3] the account party (the customer obtaining the L/C) is now the *applicant*;[4] the confirming bank is now the *confirmer*.[5] Any "document" involved in the transaction expressly may be "presented in a written or other medium permitted by the letter of credit."[6] Likewise, the L/C itself expressly may be issued "in any form that is a record,"[7] which is defined to mean "information that is inscribed on a tangible medium, or that is *stored in an electronic or other medium* and is retrievable in perceivable form."[8]

Treatment of electronic transmittal of L/C documents is handled somewhat differently under UCP practice. In April 2002, the ICC issued the eUCP (version 1.0), a new electronic supplement to the ICC's UCP 500.[9] Review the eUCP and consider the problems posed in the following questions.

QUESTIONS

1. Buyer and Seller sign a contract for the sale of goods providing for payment *via* a letter of credit (L/C), but the contract does not say anything about the method of presenting documents for payment under the L/C. Seller sends Issuer Bank a pdf.doc containing a draft and supporting documents that would clearly have satisfied the L/C conditions for payment if they had been paper documents. Bank's employee looks at the pdf.doc on the computer screen, but does not process Seller's payment demand. The L/C eventually expires. Would Bank be liable to Seller under the revised UCC article 5? Under the UCP?

2. Buyer and Seller specify that the L/C is subject to UCP 500. Seller sends Issuer Bank a pdf.doc containing a draft and supporting documents that would clearly have satisfied the L/C conditions for payment if they had been paper documents. Bank's employee looks at the pdf.doc on the computer screen, but does not process Seller's payment demand. The L/C eventually expires. Is Bank liable to Seller?

3. Buyer and Seller specify that the L/C is subject to "the eUCP to the extent that its provisions are different from those of the Uniform Commercial Code [(UCC)] article 5," which is the L/C law in the U.S. jurisdiction where Buyer has its principal place of business. Does UCP 500 or UCC art. 5 apply to this transaction?

4. Buyer and Seller specify that the L/C is subject to the eUCP. They do not specify

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2. *See* UCC § 5-102(a) (1995 Rev.) (providing definitions of basic terms).
3. *Id*. § 5-102(a)(1).
4. *Id*. § 5-102(a)(2).
5. *Id*. § 5-102(a)(4).
6. *Id*. § 5-102(a)(6).
7. *Id*. § 5-104.
8. *Id*. § 5-102(a)(14) (emphasis added).
9. *See* press release concerning eUCP. The text of the eUCP is included in the Supplement, along with selected provisions from the UCP 500.

a format for electronic presentation of documents. Seller sends Issuer Bank documents in pdf format. Bank does not have Adobe Acrobat on its computer system and cannot open the pdf document files. What are Bank's rights and responsibilities in this transaction?

[INSERT FIGURE 2-2 HERE]

FIGURE 2-2
Standard Form of Letter of Credit
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d. The Draft or Bill of Exchange

A draft or bill of exchange (Figure 2-3, *infra*) is the document that orders or directs the payment called for under the sale transaction or the L/C. It is an order in writing by one person (the *drawer*, typically the seller) to another (the *drawee*, typically a bank), signed by the drawer and requiring the drawee to pay on demand, or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person (the *payee*) or to bearer. Note that the drawee does not owe an obligation to the payee to pay the draft, unless the drawee signs ("accepts") the draft, at which point the drawee becomes an *acceptor*, with its own obligation to pay the instrument. Whether the instrument is accepted or not, it is likely to be *negotiable*,[1] meaning that it may be freely transferred for value in a secondary market that is independent[2] of the trade transaction itself. A seller who has a right to obtain payment through a draft might sell ("discount") the draft in this market in order to obtain immediate funds, rather than wait for payment in the course of the sales transaction. Accepted drafts are particularly desirable in this regard, since they will be negotiable at a relatively lower discount because they have the credit of an international bank behind them, not just that of the parties to the underlying commercial transaction. In U.S. practice, for example, these "banker's acceptances," as foreign-trade derived assets, are eligible for investment by national banks and may also be eligible for purchase by the Federal Reserve System. This eligibility makes the secondary market for these instruments quite broad, which of course supports and encourages international trade transactions.

e. The Entire Transaction

It is now possible to work through the entire transaction. Assume that a Tokyo exporter and a Chicago importer wish to enter into a transnational sales transaction involving 50 television sets for $100 each:

(1) Tokyo exporter and Chicago importer enter a contract, perhaps by telex, quoting the prices, quantities, dates, and particular trade terms.

(2) Chicago importer obtains a letter of credit from its bank. It may have to pay in advance for this letter. Details aside, this letter will say in essence:

> Dear Tokyo Bank:
>
> On receipt of a bill of lading for 50 television sets, we will honor your sight draft in the amount of $5,000.
>
> [signed] *Chicago Bank*

---

1. *See, e.g.*, UCC § 3-104 (defining "negotiable instrument" for commercial law purposes).

2. By "independent" in this sense, we mean that the purchaser of the instrument who meets the requirements of being a "holder in due course," *id.* § 3-302, will be able to obtain payment of the instrument without regard to most contract defenses and claims that the buyer of the goods might have against the seller pursuant to the underlying contract for the sale of the goods. *Id.*§ 3-305(b).

[INSERT FIGURE 2-3 HERE]

FIGURE 2-3
Sample Draft
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This letter of credit would probably also require a number of insurance and customs certificates.

(3) Chicago importer (or bank) sends the letter of credit to Tokyo exporter (or bank).

(4) Tokyo exporter can now confidently deliver the goods to the carrier, who will provide a bill of lading, saying, in essence, that 50 television sets have been received on board. Exporter will negotiate this bill to the order of Chicago bank, and, through Tokyo bank, send it along with a draft and the other necessary documents to Chicago Bank. The draft in appropriate form will essentially say:

> Chicago Bank,
>
> On sight, pay to order of Tokyo Bank $5,000.
>
> [signed] *Tokyo Bank*

(5) On receiving the documents and seeing that they are all in proper form, Chicago Bank will make the payment to Tokyo bank and negotiate the bill of lading to its customer.

(6) Tokyo bank will pay its customer (if it has not done so already).

(7) Chicago importer, as holder of the bill of lading, will be able to obtain the television sets from the carrier.

The approach offers many mechanisms for credit. Importer's bank can simply offer credit to its client and permit the process to proceed as described above, paying exporter when the letter of credit is negotiated, but not receiving payment from its client until later. By using a time draft, under which importer bank (and presumably importer) is not required to pay for a specified number of days, the seller can extend short-term credit. This credit gives the buyer time to resell the goods and obtain the funds for their initial purchase; it is safe for the seller, who can rely on the bank's credit standing rather than on that of the buyer. Since importer's bank does face an exposure with this approach, it will probably not be willing to commit itself to honor such a time draft without taking a security interest in the goods at the time the documents are negotiated. And when the time draft is used, no matter what the arrangements at the importer's end, it need not be the seller who actually extends the credit from the exporter's end. Exporter may be able to discount the acceptance to its bank or a third party, as discussed above, and thus immediately obtain use of the money. The negotiated acceptance will eventually be presented to importer's bank for full payment at the appropriate time.

As the following case shows, the fundamental legal principle associated with the documentary sale concept is that the bank can and must ensure that the documents conform with the letter of credit-but is almost completely unconcerned with whether the goods conform to the underlying contract. The basic working assumption is that breach-of-warranty style disputes should not be allowed to bar initial payment. It is assumed better to honor the letter of credit and bring breach-of-warranty problems to the exporter's courts if necessary; otherwise (real or bogus) quality disputes would render payment so uncertain as to be a barrier to trade.

MAURICE O'MEARA CO. v. NATIONAL PARK BANK OF NEW YORK

239 N.Y. 386,146 N.E. 636 (N.Y. Ct. App. 1925)

MCLAUGHLIN, J.

This action was brought to recover damages alleged to have been sustained by the plaintiff's assignor, Ronconi & Millar, by defendant's refusal to pay three sight drafts against a confirmed irrevocable letter of credit. The letter of credit was in the following form:

The National Park Bank of New York.
Our Credit No. 14956 October 28, 1920.

Messrs. Ronconi & Millar, 49 Chambers Street, New York City, N.Y.--Dear Sirs: In accordance with instructions received from the Sun-Herald Corporation of this city, we open a confirmed or irrevocable credit in your favor for account of themselves, in amount of $224,853.30, covering the shipment of 1,322 -2/3 tons of newsprint paper in 72-1/2" and 36-1/2" rolls to test 11-12, 32 lbs. at 8-1/2¢ per pound net weight-delivery to be made in December, 1920, and January 1921.

Drafts under this credit are to be drawn at sight on this bank, and are to be accompanied by the following documents of a character which must meet with our approval:

Commercial invoice in triplicate.

Weight returns.

Negotiable dock delivery order actually carrying with it control of the goods.

This is a confirmed or irrevocable credit, and will remain in force to and including February 15, 1921, subject to the conditions mentioned herein.

When drawing drafts under this credit, or referring to it, please quote our number as above.

Very truly yours,

R. Stuart, Assistant Cashier.
(R. C.)

The complaint alleged the issuance of the letter of credit; the tender of three drafts, the first on the 17th of December, 1920, for $46,301.71, the second on January 7, 1921, for $41,416.34, and the third on January 13, 1921, for $32,968.35. Accompanying the first draft were the following documents:

1. Commercial invoice of the said firm of Ronconi & Millar in triplicate, covering three hundred (300) thirty-six and one-half (36-1/2) inch rolls of newsprint paper and three hundred (300) seventy-two and one-half (72-1/2) inch rolls of newsprint paper, aggregating a net weight of five hundred and forty-four thousand seven hundred and twenty-six pounds (544,726), to test eleven (11), twelve (12), thirty-two (32) pounds.
2. Affidavit of Elwin Walker, verified December 16, 1920, to which were annexed samples of newsprint paper, which the said affidavit stated to be representative of the shipment covered by the accompanying invoices and to test twelve (12) points, thirty-two (32) pounds.
3. Full weight returns in triplicate.

4. Negotiable dock delivery order on the Swedish American Line, directing delivery to the order of the National Park Bank of three hundred (300) rolls of newsprint paper seventy-two and one-half (72-1/2) inches long and three hundred (300) half rolls of newsprint paper.

The documents accompanying the second draft were similar to those accompanying the first, except as to the number of rolls, weight of paper, omission of the affidavit of Walker, but with a statement: "Paper equal to original sample in test 11/12-32 pounds:" and a negotiable dock delivery order on the Seager Steamship Company, Inc. The complaint also alleged defendant's refusal to pay, a statement of the amount of loss upon the resale of the paper due to a fall in the market price, expenses for lighterage, cartage, storage, and insurance amounting to $3,045.02, an assignment of the cause of action by Ronconi & Millar to the plaintiff, and a demand for judgment.

The answer denied, upon information and belief, many of the allegations of the complaint, and set up (a) as an affirmative defense, that plaintiff 's assignor was required by the letter of credit to furnish to the defendant "evidence reasonably satisfactory" to it that the paper shipped to the Sun-Herald Corporation was of a bursting or tensile strength of I 1 to 12 points at a weight of paper of 32 pounds; that neither the plaintiff nor its assignor, at the time the drafts were presented, or at any time thereafter, furnished such evidence; (b) as a partial defense, that, when the draft for $46,301.71 was presented, the defendant notified the plaintiff there had not been presented "evidence reasonably satisfactory" to it, showing that the newsprint paper referred to in the documents accompanying said drafts was of the tensile or bursting strength specified in the letter of credit; that thereupon an agreement was entered into between plaintiff and defendant that the latter should cause a test to be made of the paper represented by the documents then presented, and, if such test showed that the paper was up to the specifications of the letter of credit, defendant would make payment of the draft; (c) for a third separate and distinct defense that the paper tendered was not, in fact, of the tensile or bursting strength specified in the letter of credit. . . .

After issue had been joined the plaintiff moved, upon the pleadings and affidavits, pursuant to rule 113 of the Rules of Civil Practice, to strike out the answer and for summary judgment. . . .

The motion for summary judgment was denied and the defendant appealed to the Appellate Division, where the order denying the same was unanimously affirmed, leave to appeal to this court granted, and the following question certified: "Should the motion of the plaintiff for summary judgment herein have been granted?" . . .

I am of the opinion that the order of the Appellate Division and the Special Term should be reversed and the motion granted. The facts set out in defendant's answer and in the affidavits used by it in opposition to the motion are not a defense to the action.

The bank issued to plaintiff's assignor an irrevocable letter of credit, a contract solely between the bank and plaintiff's assignor, in and by which the bank agreed to pay sight drafts to a certain amount on presentation to it of the documents specified in the letter of credit. This contract was in no way involved in or connected with, other than the presentation of the documents, the contract for the purchase and sale of the paper mentioned. That was a contract between buyer and seller, which in no way concerned the bank. The bank's obligation was to pay sight drafts when presented if accompanied by genuine documents specified in the letter of credit. If the paper when delivered did not correspond to what had been purchased, either in weight, kind or quality, then the purchaser had his remedy against the seller for damages. Whether the paper was what

the purchaser contracted to purchase did not concern the bank and in no way affected its liability. It was under no obligation to ascertain, either by a personal examination or otherwise, whether the paper conformed to the contract between the buyer and seller. The bank was concerned only in the drafts and the documents accompanying them. This was the extent of its interest. If the drafts, when presented, were accompanied by the proper documents, then it was absolutely bound to make the 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. This view, I think, is the one generally entertained with reference to a bank's liability under an irrevocable letter of credit of the character of the one here under consideration....

The defendant had no right to insist that a test of the tensile strength of the paper be made before paying the drafts; nor did it even have a right to inspect the paper before payment, to determine whether it in fact corresponded to the description contained in the documents. The letter of credit did not so provide. All that the letter of credit provided was that documents be presented which described the paper shipped as of a certain size, weight, and tensile strength. To hold otherwise is to read into the letter of credit something which is not there, and this the court ought not to do, since it would impose upon a bank a duty which in many cases would defeat the primary purpose of such letters of credit. This primary purpose is an assurance to the seller of merchandise of prompt payment against documents.

It has never been held, so far as I am able to discover, that a bank has the right or is under an obligation to see that the description of the merchandise contained in the documents presented is correct. A provision giving it such right, or imposing such obligation, might, of course, be provided for in the letter of credit. The letter under consideration contains no such provision. If the bank had the right to determine whether the paper was of the tensile strength stated, then it might be pertinent to inquire how much of the paper must it subject to the test. If it had to make a test as to tensile strength, then it was equally obligated to measure and weigh the paper. No such thing was intended by the parties and there was no such obligation upon the bank. The documents presented were sufficient. The only reason stated by defendant in its letter of December 18, 1920, for refusing to pay the draft, was that: "There has arisen a reasonable doubt regarding the quality of the newsprint paper. ... Until such time as we can have a test made by an impartial and unprejudiced expert we shall be obliged to defer payment."

This being the sole objection, the only inference to be drawn therefrom is that otherwise the documents presented conformed to the requirements of the letter of credit. All other objections were thereby waived....

The orders appealed from should therefore be reversed and the motion granted, with costs in all courts. The question certified is answered in the affirmative.

CARDOZO, J. (dissenting).

I am unable to concur in the opinion of the court.

I assume that no duty is owing from the bank to its depositor which requires it to investigate the quality of the merchandise. *Laudisi v. American Exchange Nat. Bank*, 239 N. Y. 234, 146 N. E. 347. I dissent from the view that, if it chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise which the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. We are to bear in mind that this

controversy is not one between the bank on the 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 we lose sight of the true nature of the transaction when we view the bank as acting upon the credit of its customer to the exclusion of all else. It acts not merely upon the credit of its customer, but upon the credit also of the merchandise which is to be tendered as security. The letter of credit is explicit in its provision that documents sufficient to give control of the goods shall be lodged with the bank when drafts are presented. I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face. A different question would be here if the defects had no relation to the description in the documents. In such circumstances it would be proper to say that a departure from the ten-ns of the contract between the vendor and the vendee was of no moment to the bank. That is not the case before us. If the paper was of the quality stated in the defendant's answer the documents were 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, or at the very least, the difference between the value of the thing described and the value of the thing received. If payment might have been recovered the moment after it was made, the seller cannot coerce payment if the truth is earlier revealed.

We may find persuasive analogies in connection with the law of sales. One who promises to make payment in advance of delivery and inspection may be technically in default if he refuses the promised payment before inspection has been made. None the less, if the result of the inspection is to prove that the merchandise is defective, the seller must fail in an action for the recovery of the price. The reason is that "the buyer would have been entitled to recover back the price if he had paid it without inspection of the goods." 2 Williston on Sales (2d Ed.) §§479, 576.

I think the defendant's answer and the affidavits submitted in support of it are sufficient to permit a finding that the plaintiff's assignor-s misrepresented the nature of the shipment. The misrepresentation does not cease to be a defense, partial if not complete, though it was innocently made. . . .

The order should be affirmed and the question answered "No."

NOTE

The next case shows what happens to the *O'Meara* doctrine when the exporter pushes the situation too far. Note that, earlier in the litigation, the importer had sued the bank to enjoin it from honoring the letter of credit; this litigation pattern is typical of letter-of-credit disputes. Finally, in reading the case, be sure to consider both the policy issues underlying the U.C.C. rules, and the wisdom of applying these rules to Pakistani banks.

UNITED BANK LTD. v. CAMBRIDGE SPORTING GOODS CORP.

41 N.Y.2d 254, 369 N.E.2d 943 (1976)

GABRIELLI, JUSTICE.

In April, 1971 appellant Cambridge Sporting Goods Corporation (Cambridge) entered into a contract for the manufacture and sale of boxing gloves with Duke Sports (Duke), a Pakistani corporation. Duke committed itself to the manufacture of 27,936 pairs of boxing gloves at a sale price of $42,576.80; and arranged with its Pakistani bankers, United Bank Limited (United) and The Muslim Commercial Bank (Muslim), for the financing of the sale. Cambridge was requested by these banks to cover payment of the purchase price by opening an irrevocable letter of credit with its bank in New York, Manufacturers Hanover Trust Company (Manufacturers). Manufacturers issued an irrevocable letter of credit obligating it, upon the receipt of certain documents indicating shipment of the merchandise pursuant to the contract, to accept and pay, 90 days after acceptance, drafts drawn upon Manufacturers for the purchase price of the gloves. . . .

Despite the cancellation of the contract, Cambridge was informed on July 17, 1971 that documents had been received at Manufacturers from United purporting to evidence a shipment of the boxing gloves under the terms of the canceled contract. The documents were accompanied by a draft, dated July 16,1971, drawn by Duke upon Manufacturers and made payable to United, for the amount of $21,288.40, one half of the contract price of the boxing gloves. A second set of documents was received by Manufacturers from Muslim, also accompanied by a draft, dated August 20, and drawn upon Manufacturers by Duke for the remaining amount of the contract price.

An inspection of the shipments upon their arrival revealed that Duke had shipped old, unpadded, ripped and mildewed gloves rather than the new gloves to be manufactured as agreed upon. Cambridge then commenced an action against Duke in Supreme Court, New York County, joining Manufacturers as a party, and obtained a preliminary injunction prohibiting the latter from paying drafts drawn under the letter of credit; subsequently, in November, 1971 Cambridge levied on the funds subject to the letter of credit and the draft, which were delivered by Manufacturers to the Sheriff in compliance therewith. Duke ultimately defaulted in the action and judgment against it was entered in the amount of the drafts, in March, 1972.

The present proceeding was instituted by the Pakistani banks to vacate the levy made by Cambridge and to obtain payment of the drafts on the letter of credit. . . .

This case does not come before us in the typical posture of a lawsuit between the bank issuing the letter of credit and presenters of drafts drawn under the credit seeking payment (see, generally, White and Summers, Uniform Commercial Code, § 18-6, pp.619-628). Because Cambridge obtained an injunction against payment of the drafts and has levied against the proceeds of the drafts, it stands in the same position as the issuer, and, thus, the law of letters of credit governs the liability of Cambridge to the Pakistani banks.[1] Article 5 of the Uniform Commercial Code, dealing with letters of

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1. Cambridge has no direct liability on the drafts because it is not a party to the drafts which were drawn on Manufacturers by Duke as drawer; its liability derives from the letter of credit which authorizes the drafts to be drawn on the issuing banks. Since Manufacturers has paid the proceeds of the drafts to the Sheriff pursuant to the levy obtained in the prior proceeding, it has discharged its obligation under the credit and is not involved in this proceeding.

credit, and the Uniform Customs and Practice for Documentary Credits promulgated by the International Chamber of Commerce set forth the duties and obligations of the issuer of a letter of credit.[2] A letter of credit is a commitment on the part of the issuing bank that it will pay a draft presented to it under the terms of the credit, and if it is a documentary draft, upon presentation of the required documents of title (see Uniform Commercial Code, §5-103). Banks issuing letters of credit deal in documents and not in goods and are not responsible for any breach of warranty or nonconformity of the goods involved in the underlying sales contract (see Uniform Commercial Code, §5-114, subd. [1]; Uniform Customs and Practice, General Provisions and Definitions [c] and article 9; O'Meara Co. v. National Park Bank of N.Y., 239 N.Y. 386,146 N.E. 636; . . . 1955 Report of N.Y. Law Rev. Comm., vol. 3, Study of Uniform Commercial Code, pp. 1654-1655). Subdivision (2) of section 5-114, however[,] indicates certain limited circumstances in which an issuer may properly refuse to honor a draft drawn under a letter of credit or a customer may enjoin an issuer from honoring such a draft.[3] Thus, where "fraud in the transaction" has been shown and the holder has not taken the draft in circumstances that would make it a holder in due course, the customer may apply to enjoin the issuer from paying drafts drawn under the letter of credit (see 1955 Report of N.Y. Law Rev. Comm., vol. 3, pp. 1654-1659). This rule represents a codification of precode case law most eminently articulated in the landmark case of Sztejn v. Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631, Shientag, J., where it was held that the shipment of cowhair in place of bristles amounted to more than mere breach of warranty but fraud sufficient to constitute grounds for enjoining payment of drafts to one not a holder in due course. . . . Even prior to the *Sztejn* case, forged or fraudulently procured documents were proper grounds for avoidance of payment of drafts drawn under a letter of credit (Finkelstein, Legal Aspects of Commercial Letters of Credit, pp. 231, 236-247); and cases decided after the enactment of the code have cited *Sztejn* with approval. . . .

The history of the dispute between the various parties involved in this case reveals that Cambridge had in a prior, separate proceeding successfully enjoined Manufacturers

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2. It should be noted that the Uniform Customs and Practice controls, in lieu of article 5 of the code, where, unless otherwise agreed by the parties, a letter of credit is made subject to the provisions of the Uniform Customs and Practice by its terms or by agreement, course of dealing or usage of trade (Uniform Commercial Code, §5-102, subd. [4]). No proof was offered that there was an agreement that the Uniform Customs and Practice should apply, nor does the credit so state (*cf.* Oriental Pacific [U.S.A.] v. Toronto Dominion Bank, 78 Misc. 2d 819, 357 N.Y.S.2d 957). Neither do the parties otherwise contend that their rights should be resolved under the Uniform Customs and Practice. However, even if the Uniform Customs and Practice were deemed applicable to this case, it would not, in the absence of a conflict, abrogate the precode case law (now codified in Uniform Commercial Code, §5-114) and that authority continues to govern even where article 5 is not controlling (*see* White and Summers, *op. cit.*, pp. 613-614, 624-625). Moreover, the Uniform Customs and Practice provisions are not in conflict nor do they treat with the subject matter of §5-114 which is dispositive of the issues presented on this appeal *(see* Banco Tornquist, S. A. v. American Bank & Trust Co., 71 Misc. 2d 874, 875, 337 N.Y.S.2d 489; Intraworld Ind. v. Girard Trust Bank, 461 Pa. 343, 336 A.2d 316, 322; Harfield, Practice Commentary, McKinney's Cons. Laws of N.Y., Book 62 1/2, Uniform Commercial Code, §5-114, p. 686). Thus, we are of the opinion that the Uniform Customs and Practice, where applicable, does not bar the relief provided for in §5-114 of the code.

3. Subdivision (2) of section 5-114 of the Uniform Commercial Code provides that,

> [u]nless otherwise agreed when documents appear on their face to comply with the terms of a credit but . . . there is fraud in the transaction (a) the issuer must honor the draft or demand for payment if honor is demanded by a . . . holder of the draft . . . which has taken the draft . . . under the credit and under circumstances which would make it a holder in due course (Section 3-302) . . . ; and
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> (b) in all other cases as against its customer, an issuer acting in good faith may honor the draft . . .. 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.

from paying the drafts and has attached the proceeds of the drafts. It should be noted that the question of the availability and the propriety of this relief is not before us on this appeal. The petitioning banks do not dispute the validity of the prior injunction nor do they dispute the delivery of worthless merchandise. Rather, on this appeal they contend that as holders in due course they are entitled to the proceeds of the drafts irrespective of any fraud on the part of Duke (see Uniform Commercial Code, §5-114, subd. [2], par. [b]). Although precisely speaking there was no specific finding of fraud in the transaction by either of the courts below, their determinations were based on that assumption. The evidentiary facts are not disputed and we hold upon the facts as established, that the shipment of old, unpadded, ripped and mildewed gloves rather than the new boxing gloves as ordered by Cambridge, constituted fraud in the transaction within the meaning of subdivision (2) of section 5-114. It should be noted that the drafters of section 5-114, in their attempt to codify the *Sztejn* case and in utilizing the term "fraud in the transaction", have eschewed a dogmatic approach and adopted a flexible standard to be applied as the circumstances of a particular situation mandate.[5] It can be difficult to draw a precise line between cases involving breach of warranty (or a difference of opinion as to the quality of goods) and outright fraudulent practice on the part of the seller. To the extent, however, that Cambridge established that Duke was guilty of fraud in shipping, not merely nonconforming merchandise, but worthless fragments of boxing gloves, this case is similar *to Sztejn.*

If the petitioning banks are holders in due course they are entitled to recover the proceeds of the drafts but if such status cannot be demonstrated their petition must fail.[6] The parties are in agreement that section 3-307 of the code governs the pleading and proof of holder in due course status and that section provides:

> (1) Unless specifically denied in the pleadings each signature on an instrument is admitted. When the effectiveness of a signature is put in issue
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> (a) the burden of establishing it is on the party claiming under the signature; but
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> (b) the signature is presumed to be genuine or authorized except where the action is to enforce the obligation of a purported signer who has died or become incompetent before proof is required.
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> (2) When signatures are admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defense.
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> (3) After it is shown that a defense exists a person claiming the rights of a holder in due course has the burden of establishing that he or some person under whom he claims is in all respects a holder in due course.

Even though section 3-307 is contained in article 3 of the code dealing with negotiable instruments rather than letters of credit, we agree that its provisions should control in the instant case. Section 5-114 (subd. [2], par. [a]) utilizes the holder in due course criteria of section 3-302 of the code to determine whether a presenter may recover on drafts

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5. In its original version section 5-114 contained the language "fraud in a required document" *(see* 1955 Report of N.Y. Law Rev. Comm., pp 1655-1658).

6. Although several commentators have expressed a contrary view, the weight of authority supports the proposition that fraud on the part of the seller-beneficiary may not be interposed as a defense to payment against a holder in due course to whom a draft has been negotiated *(see* Finkelstein, *op. cit.*, p. 246, Ward and Harfield, Bank Credits and Acceptances, pp. 94-98; 1955 Report of N.Y. Law Rev. Comm., pp. 1662-1663, and authorities cited therein). This approach represents the better view that as against two innocent parties (the buyer and the holder in due course) the former having chosen to deal with the fraudulent seller, should bear the risk of loss *(see* Harfield, Practice Commentary, McKinney's Cons. Laws of N.Y., Book 621/2, Uniform Commercial Code, §5-114, pp. 686-687).

despite fraud in the sale of goods transaction. It is logical, therefore, to apply the pleading and practice rules of section 3-307 in the situation where a presenter of drafts under a letter of credit claims to be a holder in due course. In the context of section 5-114 and the law of letters of credit, however, the "defense" referred to in section 3-307 should be deemed to include only those defenses available under subdivision (2) of section 5-114, i.e., noncompliance of required documents, forged or fraudulent documents or fraud in the transaction. In the context of a letter of credit transaction and, specifically subdivision (2) of section 5-114, it is these defenses which operate to shift the burden of proof of holder in due course status upon one asserting such status. . . . Thus, a presenter of drafts drawn under a letter of credit must prove that it took the drafts for value, in good faith and without notice of the underlying fraud in the transaction (Uniform Commercial Code, §3-302). . . .

In order to qualify as a holder in due course, a holder must have taken the instrument "without notice . . . of any defense against . . . it on the part of any person" (Uniform Commercial Code, §3-302, subd. [1], par. [c]). Pursuant to subdivision (2) of section 5-114 fraud in the transaction is a valid defense to payment of drafts drawn under a letter of credit. Since the defense of fraud in the transaction was shown, the burden shifted to the banks by operation of subdivision (3) of section 3-307 to prove that they were holders in due course and took the drafts without notice of Duke's alleged fraud. As indicated in the Official Comment to that subdivision, when it is shown that a defense exists, one seeking to cut off the defense by claiming the rights of a holder in due course "has the full burden of proof by a preponderance of the total evidence" on this issue. This burden must be sustained by "affirmative proof" of the requisites of holder in due course status (see Official Comment, McKinney's Cons. Laws of N.Y., Book 621/2, Uniform Commercial Code, §3-307, p. 212). It was error for the trial court to direct a verdict in favor of the Pakistani banks because this determination rested upon a misallocation of the burden of proof; and we conclude that the banks have not satisfied the burden of proving that they qualified in all respects as holders in due course, by any affirmative proof. The only evidence introduced by the banks consisted of conclusory answers to the interrogatories which were improperly admitted by the Trial judge. . . . The failure of the banks to meet their burden is fatal to their claim for recovery of the proceeds of the drafts and their petition must therefore be dismissed. . . .

NOTE

The next case involves an L/C transaction that was subject to the Uniform Customs and Practice for Documentary Credits,[1] rather than UCC article 5. Does that fact seem to make much of a difference to the outcome of the case?

BANK OF COCHIN LTD. V. MANUFACTURERS HANOVER TRUST

612 F. Supp. 1533 (S.D.N.Y. 1985), *affirmed*, 808 F.2d 209 (2d Cir. 1986)

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1. Uniform Customs and Practice for Documentary Credits (1974 Revision), Int'l Chamber of Commerce, Pub. No. 290. The current version of the UCP is UCP 500, a 1993 version in force as of 1 January 1994. UCP 500 has itself been supplemented by the eUCP Version 1.0, in force as of 1 April 2002. The eUCP provides supplementary rules to govern situations in which the parties provide for or permit presentation of electronic records alone or in combination with paper documents. eUCP, art.e1.a.

CANNELLA, SENIOR DISTRICT JUDGE:

[Bank of Cochin Limited (Cochin), an Indian corporation and the issuer of letter of credit BB/VN/41/80, commenced this diversity action against Manufacturers Hanover Trust Company (MHT), a New York corporation that acted as the confirming bank on the letter. Cochin seeks recovery of the amount paid by MHT, thereafter debited to Cochin's account at MHT, on drawings negotiated in New York between MHT and St. Lucia Enterprises, Ltd. (St. Lucia). Codefendant St. Lucia, a purported New York corporation and the letter of credit beneficiary, has perpetrated a large fraud on both banks and nonparty customer Vishwa Niryat (Pvt.) Ltd. (Vishwa). Unfortunately, St. Lucia has vanished, and the court had to decide which bank would bear the loss.

[In February 1980, Vishwa had requested Cochin to issue an irrevocable letter of credit covering up to $798,000, with St. Lucia as beneficiary. The letter, which was supposed to expire on April 15, 1980, covered the anticipated purchase and shipment of 1,000 metric tons of aluminum melting scrap consisting of aluminum beverage cans. Vishwa's application for the L/C required that St. Lucia supply the following documents and shipment conditions as a prerequisite to payment:

> [Six copies of signed invoices;
> One set of clean shipped on board bills of lading;
> Notification of shipment to Vishwa;
> A maritime insurance policy covering civil unrest, marine and war risks;
> A certificate of analysis from Lloyd's of London ["Lloyd's"] confirming the quantity, quality and shipment of the aluminum scrap;
> Shipment by conference or first class vessel; and,
> Shipment by a non-Pakistani vessel.

[On February 14, 1980, Cochin requested MHT to supply financial information on St. Lucia. MHT responded by telex the following day that St. Lucia did not maintain an MHT account. A thorough check of normal credit sources did not reveal any pertinent information. On February 22, Cochin telexed the terms and conditions of the L/C to MHT requested that MHT advise "St. Lucia Enterprises Ltd." of the establishment of the letter and to add MHT's confirmation. The L/C was issued subject to the UCP for Documentary Credits. The documentary and other requirements for the L/C as set forth in Cochin's telex included:

> [Sight drafts of the invoice value in duplicate;
> Six copies of the signed invoices showing that the aluminum was covered under notice 44-ITC(PN) 79;
> One set of clean shipped on board bills of lading to the order of Cochin;
> A certificate of United States origin in triplicate;
> A certificate of analysis of the aluminum from Lloyd's;
> Shipment from a United States port to Bombay;
> A marine insurance policy issued by a first class insurance company;
> A packing list in triplicate;
> One set of nonnegotiable documents to be sent directly to Vishwa immediately after shipment documented by a "cable advise" to Vishwa; and,
> Shipment by conference or first-class vessel.

[On February 25, MHT mailed written advice of establishment of the L/C to St. Lucia and confirmed the amended L/C on February 29. Cochin amended certain terms on four occasions in March and April 1980. MHT mailed advices of these amendments to St. Lucia from March to May and sent copies to Cochin, which were received without comment. The final amended version of the L/C contained the following relevant terms and conditions:

> [Sight drafts of the invoice values;
> Six copies of the signed invoices;
> One set of clean shipped on board bills of lading;
> A west European certificate of origin;
> A certificate of analysis of the aluminum scrap from Lloyd's or another international testing agency;
> Shipment from a west European port to Bombay;
> A maritime insurance policy, covering note 429711, to be confirmed by St. Lucia's cable to Oriental Fire and General Insurance Co. ("Oriental");
> A packing list in triplicate;
> One set of nonnegotiable documents to be sent to Vishwa and a confirming cable to Vishwa;
> A certification from Lloyd's or the shipping company that the ship was a first class or approved non-Pakistani vessel;
> St. Lucia's certification that it had complied with all terms of the letter of credit;
> Shipment by May 31, 1980; and,
> Letter of credit expiration on June 15, 1980.]

The aluminum was allegedly shipped on May 29, 1980 from Bremen, West Germany to Bombay on the M/V Betelguese. On June 2, St. Lucia established an account at a Manhattan office of Citibank, N.A. ["Citibank"], the collecting bank, in the name of St. Lucia Enterprises, Ltd. On June 9, St. Lucia presented MHT with documents required by the letter of credit and ten sight drafts amounting to $796,603.50, payable to St. Lucia Enterprises. The documents included five copies of the invoices, a clean shipped on board bill of lading, a St. Lucia certification that the aluminum was of west European origin, a certificate of analysis by an international Dutch materials testing agent, a telex confirmation of a telephone message to Oriental that the aluminum had been shipped to Bombay pursuant to covernote 4291, a packing list in triplicate, a St. Lucia certification that one set of nonnegotiable documents had been sent to Vishwa and that Vishwa had been advised by cable, certifications from the shipping company that the M/V Betelguese was an approved first class Panamanian vessel, and a St. Lucia cover letter specifying the documents submitted and requesting payment from MHT. The St. Lucia letter and certification were on the letterhead of "St. Lucia Enterprises" and were signed by "D Agney".

MHT compared the documents against the requirements of the letter and determined that they complied with all the terms and conditions. On June 13, MHT negotiated the drafts and issued a check for $798,000 payable to St. Lucia Enterprises. The check was indorsed St. Lucia Enterprises Ltd. and was deposited in the Citibank account on June 17, 1980. Citibank collected the check from MHT through normal banking channels. MHT debited Cochin's account for $798,000 on June 13. MHT sent a copy of its payment advice, the drafts and documents to Cochin by registered air mail on June 13.

Unfortunately, Cochin apparently did not receive these documents until June 21. As it turned out, St. Lucia shipped nothing to Vishwa. The documentation submitted to MHT was fraudulent in every regard; indeed, the bills of lading, quality certification and vessel certification were issued by nonexistent corporations. St. Lucia received payment on the letter of credit and Cochin has been unable to locate any party connected with the fraudulent scheme.

Cochin sent a telex to MHT on June 18, inquiring whether St. Lucia had presented documents for negotiation. MHT responded by telex on June 20 that it had paid St. Lucia $798,000 on June 13 and had forwarded the documents to Cochin at that time. On June 21, Cochin sent the following telex to MHT:

> We acknowledge receipt of the documentu [*sic*] Stop We find certain discrepencies [*sic*] in the same Stop kindly donot [*sic*] make payment against the same until we telex you otherwise Stop

On June 23, MHT replied to Cochin's telex as follows:

> Reference your telex June 21 credit BB VN 4180 our 500748 Stop We note your telex fails to give reason fro [*sic*] rejection documents as required UCP Article 8 Stop According our records documents fully complied credit terms and beneficiary already paid therefore we cannot accept your refusal of documents.

By telex dated June 27, Cochin informed MHT of alleged defects in the documents apparently uncovered by Vishwa: (1) St. Lucia's cable to Oriental showed the wrong insurance covernote number of 4291 instead of 429711; (2) St. Lucia did not submit "proof" that a set of nonnegotiable documents and confirming cable had been sent to Vishwa; (3) only one set of documents showed the original certificate of origin whereas the rest included only photocopies; and (4) the invoice packing list and certificate of origin were not duly authenticated. Cochin also noted (5) the overpayment of $1,396.50. MHT credited Cochin's account for $1,396.50 and notified Cochin by telex on June 30.

By telex dated July 3, Cochin asked MHT to recredit its account for $796,603.50 and advised MHT that it was returning the letter of credit documents. Cochin also cited an additional discrepancy that (6) MHT had negotiated documents for St. Lucia Enterprises but that the letter of credit was established for St. Lucia Enterprises Ltd. On July 4, Cochin informed MHT by telex that the documents negotiated by MHT contained the following additional defects: (7) only five signed copies of the commercial invoices, rather than six, were forwarded and (8) documents were signed by "D Agney" without specifying his capacity at St. Lucia.

MHT responded by telex of July 14 that Cochin had failed to timely and properly specify the alleged documentary variances as required by article 8 of the 1974 UCP. The telex also noted that Cochin had failed to promptly return the documents or advise MHT that Cochin was holding the documents at MHT's disposal as required by the UCP. MHT asserted in a telex dated July 16 that it still had not received certain documents from Cochin. The parties exchanged additional telexes confirming and denying that payment was proper. Cochin[] . . . adds the additional allegations that (9) St. Lucia failed to indicate the documents submitted in drawing against the letter of credit, and (10) the shipping company certificate fails to indicate the vessel registration number. . . .

The central issue presented by this case is whether St. Lucia's demand for payment from MHT was in compliance with the conditions specified in the letter of credit. Cochin's action for wrongful honor is based upon its assertion that MHT's payment was improper because the documents submitted by St. Lucia did not comply with the letter. Neither the UCP nor the Uniform Commercial Code ["UCC"] specify whether a bank honoring a letter of credit should be guided by a standard of strict compliance with the terms of the letter.

The great weight of authority in this jurisdiction, and elsewhere, holds that an issuing or confirming bank is usually obligated to honor the beneficiary's draft only when the documents are in strict compliance with the terms of the letter of credit. . . . Thus, New York courts have traditionally held that letter of credit law requires a beneficiary to strictly comply with the conditions of the letter. . . . Additionally, this Court has previously held that "[a] bank's obligation in a letter of credit transaction is defined by the contract between the bank and its customer. It is obliged to pay only if the documents submitted strictly comply with the essential requirements of the letter of credit." *Corporacion de Mercadeo Agricola v. Pan American Fruit & Produce Corp.*, Memorandum Decision at 4-5, 75 Civ. 1611 (JMC) (S.D.N.Y. Apr. 13, 1976), *quoted in Corporacion de Mercadeo Agricola v. Mellon Bank*, 608 F.2d 43, 48 n. 1 (2d Cir. 1979). This principle of strict compliance has been recently reaffirmed by the Second Circuit and the New York Court of Appeals. *See Beyene v. Irving Trust Co.*, 762 F.2d 4, 6 (2d Cir. 1985) . . . ; *Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, N.A.*, 707 F.2d 680, 682 (2d Cir. 1983) . . . ; *Marino Indus. v. Chase Manhattan Bank, N.A.*, 686 F.2d 1112, 114 (2d Cir. 1982) . . . ; *United Commodities-Greece v. Fidelity Int'l Bank*, 64 N.Y.2d 449, 455, 478 N.E.2d 172, 174, 489 N.Y.S.2d 31, 33 (1985). . . .

Courts and commentators have noted, however, that New York appears to maintain a bifurcated standard of compliance. . . . This approach calls for a strict compliance standard when the bank is sued by the beneficiary for wrongful dishonor but allows for a substantial compliance test when the bank is sued by the customer for wrongful honor. The stated rationale for the bifurcated standard is that it accords the bank flexibility in reacting to "a cross-fire of pressures . . . especially in times of falling commodity prices," . . . by limiting the liability burden on the bank, which might otherwise be caught between the "rock of a customer insisting on dishonor for highly technical reasons, and the hard place of a beneficiary threatening to sue for wrongful dishonor." . . .

MHT correctly asserts that Cochin was its "customer" in this transaction and therefore argues that a substantial compliance standard should be used to test its review of St. Lucia's documents. Although the ultimate customer, Vishwa, may be barred from a direct action against the confirming bank because of the absence of privity,[7] . . . it is undisputed that MHT owes a duty of care to Cochin, *see* UCP art. 7 (1974), art. 15 (1983). The question then is whether the bifurcated standard applies in a lawsuit by the issuing bank against the confirming bank.

The bifurcated standard is designed to permit the bank to retain flexibility in dealing with simultaneous customer pressure to reject and beneficiary pressure to accept. This discretion ostensibly preserves the bank's ministerial function of dealing solely with

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7. The UCP suggests the better view, however, that there is a duty running from the confirming bank to the ultimate customer. *See* UCP art. 12(a) (1974), art. 20(a) (1983) ("Banks utilizing the services of another bank for the purpose of giving effect to the instructions of the applicant for the credit do so for the account and at the risk of [such applicant].") art. 12(c) (1974), art. 20(c) (1983) (customer indemnification of the confirming bank). . . .

documents and the insulation of the letter of credit from performance problems. The difficulty with applying a bifurcated substantial compliance standard to actions against a confirming bank is reflected in the realities of commercial transactions. An issuing bank's good faith discretion is most required when its customer seeks to avoid payment by objecting to inconsequential defects. Although the bank should theoretically take comfort from a substantial compliance test if it honors the beneficiary's drafts over its customer's protests, the bank would usually not want to exercise its discretion for fear that its right to indemnity would be jeopardized or that its customer would break off existing banking relationships. Accordingly, the looser test of compliance does not in practice completely remove the issuer from its position between a rock and a hard place, but has a built-in safety valve against issuer misuse if the documents strictly comply with the letter.

A confirming bank, by contrast, is usually in relatively close geographical proximity with the beneficiary and typically chosen by the beneficiary because of past dealings. Although the confirming bank should not want to injure purposely its relationship with the issuing bank, the confirming bank would usually be somewhat biased in favor of the beneficiary. Additionally, the confirming bank is not in privity with the ultimate customer, who would be most likely to become dissatisfied if a conflict is resolved by the confirming bank. A biased issuing bank that in bad faith uncovers "microscopic discrepancies," . . . would still be forced to honor the letter if the documents are in strict compliance. A biased confirming bank, however, can overlook certain larger variances in its discretion without concomittant liability. A safety mechanism against confirming bank misuse is therefore not present and it would be inequitable to let a confirming bank exercise such discretion under a protective umbrella of substantial compliance. Moreover, the facts of this case do not warrant the looser standard. MHT was not faced with a "cross-fire of pressures" or concern that a disgruntled "customer" would refuse reimbursement because Cochin had sufficient funds on deposit with MHT. The Court also notes that the bifurcated substantial compliance standard is only a suggested approach by courts and commentators and has not actually been followed by New York courts.[8] Finally, in *Voest-Alpine Int'l Corp. v. Chase Manhattan Bank, N.A., supra*, the Court implied that confirming bank actions should be judged under a strict standard in wrongful dishonor as well as wrongful honor actions. It ruled that if the confirming bank waived discrepancies in the drafts, the confirming bank would not be entitled to

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8. In discussing New York's bifurcated standard, courts and commentators have mistakenly cited each other and the following cases as support for the proposition that New York courts use a bifurcated approach. . . . A closer reading of these cases suggests otherwise.

In *Bank of Montreal* [*v. Recknagel*, 109 N.Y. 482, 17 N.E. 217 (1888)], the New York Court of Appeals applied a strict compliance standard when it denied recovery in an action by the issuing bank for reimbursement from its customer who claimed that the bank wrongfully honored the letter of credit. The Court held that the draft advices describing shipments as "bales of hemp" were insufficient to comply with the letter of credit condition for invoices and bills of lading of "bales manilla hemp". In [*Bank of New York & Trust Co. v.*] *Atterbury Bros.*, [226 A.D. 117, 234 N.Y.S. 442 (1st Dep't 1929), *aff'd* 253 N.Y. 569, 171 N.E. 786 (1930)], the plaintiff bank successfully sued its customer for reimbursement. The Court acknowledged that the bank took a "risk" by paying to shipping documents issued to "A. James Brown" when the letter of credit specified "Arthur James Brown:. The parties, however, conceded that the intended person signed the documents. The "conclusive" points on the issue of "casein" versus "unground casein" was resolved by an "estoppel" against the customer because it had examined the documents prior to the bank's payment. The remaining objections, characterized as "afterthoughts", were dismissed on grounds of laches and because there was no possibility that a missing certificate could have misled the paying bank. . . . In *North American* [*Mars. Export Assocs. v. Chase Nat'l Bank*, 77 F.Supp. 55 (S.D.N.Y. 1948)], Judge Medina granted summary judgment to the bank against the beneficiary under a "strict compliance" standard. In *Chairmasters*, [*Inc. v. Public Nat'l Bank & Trust Co.*, 283 A.D. 704, 127 N.Y.S.2d 806 (1st Dep't 1954)], the court granted summary judgment to the defendant bank under the basic tenet that the bank's obligation to review documents for compliance is totally separate from the underlying transaction. . . .

reimbursement from the issuing bank, which timely discovered the mistakes, because "the issuing bank[] was entitled to strict compliance." 707 F.2d at 686. Accordingly, the Court finds that an issuing bank's action for wrongful honor against a confirming bank is governed by a strict compliance standard.

An analysis of the ten listed variances suggests that MHT failed to pick up two discrepancies not strictly complying with the letter of credit terms. . . .

In the final analysis, only the variances as to the Oriental covernote and the name St. Lucia Enterprises, Ltd., appear not to comply strictly with the letter of credit conditions. The inquiry is not ended at this point because courts in this Circuit have applied concepts of equitable waiver and estoppel in cases of issuer dishonor. Application of estoppel has been premised upon discoverable nonconformities that could have been cured by the beneficiary before the expiration of the letter, but were not raised by the issuing bank until its dishonor. The banks were estopped from asserting the variances because of previous assurances to the beneficiary of documentary compliance or because of silence coupled with the retention of nonconforming documents for an unreasonably long time after the beneficiary had submitted its drafts for payment. . . .

Application of waiver has been predicated upon situations in which the issuer justifies dishonor on grounds later found to have been unjustified. In these instances, all other possible grounds for dishonor are deemed to have been waived. . . . Waiver of nonconforming documents can also be found from statements by officials of the issuing bank or from customer authorization. . . .

. . . The UCP expressly provides that an issuer has the obligation to immediately notify the beneficiary by "expeditious means" of any reason for noncompliance and the physical disposition of the disputed documents. UCP art. 8(e) (1974), 16(d) (1983). The UCP also implicitly invites cure of any documentary deficiencies apparent before the letter of credit expiration by issuer notification to the beneficiary. . . . In the context of this case, "[a]n equitable approach to a strict compliance standard demands that the issuer promptly communicate all documentary defects to the beneficiary [or confirming bank], when time exists under the letter to remedy the nonconformity." . . . The Court finds that Cochin is precluded from claiming wrongful honor because of its failure to comply with the explicit notice and affirmative obligation provisions of the UCP and its implicit duty to promptly cure discoverable defects in MHT's confirming advices to St. Lucia.

The issuing bank must give notice "without delay" that the documents received are (1) being "held at the disposal" of the remitting or confirming bank or (2) "are being returned" to the second bank. UCP art. 8(e) (1974), art. 16(d) (1983). An issuing bank that fails to return or hold the documents for the second bank is precluded from asserting that the negotiation and payment were not effected in accordance with the letter of credit requirements. UCP art. 8(f) (1974), 16(e) (1983). . . . The UCP also directs that an issuing bank intending to claim noncompliance shall have a "reasonable time" to examine the documents after presentment and to determine whether to make such a claim. UCP art. 8(d) (1974), art. 16(c) (1983). The revised UCP allows explicitly for the imposition of the 16(e) sanction for failure to comply with the "reasonable time" provision as well; however, this interpretation is not clear under the parties' explicit choice of law, the 1974 UCP.

Neither the 1983 UCP nor the 1974 UCP defines what constitutes a "reasonable time" to determine if the documents are defective or notice "without delay" that the documents are being held or returned. When the UCP is silent or ambiguous, analogous UCC provisions may be utilized if consistent with the UCP. . . . The UCC provides for a

period of three banking days for the issuer to honor or reject a documentary draft for payment. N.Y. U.C.C. § 5-112(1)(a) (McKinney's 1964) (issuer-beneficiary relationship). The letter of credit was issued subject to the 1974 UCP but it is silent as to what law governs its terms. Cochin cites to Indian statutes interpreting a "reasonable time" as a factual question depending on the nature of the negotiable instrument and the usual course of dealing. Under the circumstances of this case, however, it appears that under New York's comparative interest choice of law approach, New York UCC law would apply. . . .

Cochin's failure to promptly notify MHT that it had returned the documents or that it was holding them at MHT's disposal thus violates the UCP. Cochin's telex of June 21 states that there are certain discrepancies in St. Lucia's documents, but Cochin did not advise MHT that it was returning the documents to MHT until the July 3 telex. The "reasonable time" three-day period should be the maximum time allowable for the notification "without delay" requirement. Because June 21, 1980 was a Saturday, Cochin should have complied with its notice obligations no later than June 26. The passage of an additional week before compliance precludes Cochin from asserting its wrongful honor claim. Moreover, it was not until June 27 that Cochin first specified any reason for its dishonor argument, and the St. Lucia Enterprises, *Ltd.* omission was not noted until July 4.

Cochin proposes that its failure to timely notify MHT was not violative of UCP or letter of credit policy because it caused no additional loss to MHT. Cochin argues that the defects were in any case incurable by the time Cochin received the documents, because St. Lucia had disappeared with the letter of credit proceeds. Although the UCP is not explicit, the Court finds that these provisions should be applied identically to an issuing bank's obligations to a confirming bank after the latter's honor of a demand for payment. Cochin's contention ignores the expectation in the international financial community that the parties will live up to their statutory obligations and is at odds with the basic letter of credit tenet that banks deal solely with documents, not in goods. Cochin's argument would defeat the letter of credit's function of being a swift, fluid and reliable financing device. . . .

Finally, the two documentary discrepancies could have been anticipated by Cochin and were curable before the demand for payment. Cochin received a copy of MHT's incorrect March 31 advice to St. Lucia, which mistakenly listed the insurance covernotes as 4291. Similarly, Cochin received copies of all of MHT's advices to St. Lucia, which omitted the "Ltd." from the corporate name. Cochin had sufficient notice and time to correct MHT's confirming defects to St. Lucia and is therefore estopped from asserting them.

NOTES AND QUESTIONS

1. Toys Were We, a Maryland corporation, enters into an agreement on January 15, 2002, with Fengshui, Ltd. in China to import a shipment of children’s soccer balls with a value of $200,000. Under the agreement, Fengshui is to stencil the words “Scooby Doo” on each ball. The container arrives on February 15, 2002, with each ball bearing the words “Scooty Poo.” On February 1, 2002, the error in wording had been brought to the attention of Melvin Mixup, General Manager of Toys Were We, who had ordered the soccer balls. In Melvin’s opinion, the change in wording makes the soccer balls much less attractive as an item that he can sell. Melvin made urgent appeals to First American Banking Corp, which had issued the irrevocable L/C under which the goods

were shipped, not to honor Fengshui's drafts drawn on the L/C, despite the conformity of the documents received by First American with the requirements of the L/C. Despite Melvin's frantic appeals, Tommy Toughnut, president of First American, has the bank make full payment against the documents presented. Melvin now seeks to retain you to sue First American for honoring the L/C. What counsel would you give Melvin?

2. Why is the law so clear that a bank must pay under an L/C (and normally is entitled to receive reimbursement from its customer) even when the goods are clearly not satisfactory? Note that Cardozo's position in *O'Meara* has not been generally accepted. For discussion of this body of law, *see* L. Sarna, Letters of Credit (1984); Michael P. Malloy, Hornbook on Bank Regulation §§ 5.16, 5.18-5.19, 9.20-9.21 (2d ed. 2002).

3. What if the documents do not conform with the terms of the letter of credit? What practical solution might you negotiate if it appears likely that the discrepancy is technical only? *See Banque de l'Indochine et de Suez S.A. v. J.H. Rayner (Mincing Lane) Ltd.*, [1983] 1 Lloyd's Rep. 228, 231 (dicta; noting that bank may put reasonable construction on ambiguity in L/C, but documents calling for further inquiry should be rejected); *Glencore Int'l A.G. v. Bank of China*, [1996] 1 Lloyd's Rep. 135, 141 (citing *Banque de l'Indochine*).

4.What if documents conform, but it is clear that the goods will not be delivered? For an example, see *Semetex Corp. v. UBAF Arab American Bank*, 1994 U.S. Dist LEXIS 7270 (SDNY 1994), *affirmed per curiam*, 51 F.3d 13 (2d Cir. 1995). The case involved a sale to Iraq in which the goods had been shipped and transport documents obtained just before the President froze Iraqi assets. The goods were therefore diverted to a warehouse in the United States, but the bank was directed to pay on the letter of credit.

5. Could the parties to the underlying contract involved in *O'Meara* have included contractual language concerning the letter of credit and its required documentation that would have resolved the buyer's concern over the quality of the paper?

6. In a situation like *United Bank*, what can an importer do to protect itself? One approach, common in cases where a defect will reduce value only slightly, is to agree to pay only, say, 90% of the purchase price through an L/C and the remainder by some other means of payment *after* there has been a chance to inspect the goods. What new risks does this create? Another possibility is for the letter of credit to require an expert's inspection certificate as one of the documents. For an example, *see* Banco Espanol de Credito v. State St. Bank & Trust Co., 385 F.2d 230 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968). Under what circumstances would you expect international networks of trustworthy experts to evolve?

7. Are you troubled by the *United Bank* court's extraterritorial application of the Uniform Commercial Code? What about the special New York U.C.C. provision, discussed in footnote 2 of the case, explicitly allowing the parties to agree that the Uniform Customs rather than the U.C.C. should govern a letter of credit? For a British example of a court considering the U.C.C. and following the general theme of U.S. law on fraud in the letter of credit transaction, but questioning the U.C.C.'s parallel treatment of fraud and forgery in certain contexts, see *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*, [1982] 2 W.L.R. 1039.

8. In *O'Meara*, *United Bank*, and *Cochin*, what went wrong with the L/C transaction and how do the transactional rules handle the problems that result? Should bank regulators -- as opposed to the private parties involved in the transaction -- have any interest in the resolution of such situations? We explore the regulatory interests in these transactions in § A.2, *infra*.

9. How can L/Cs be utilized to provide immediate cash to the customer of the bank obtaining the L/C? An increasingly common trend is for importers to "factor" the L/C obligation to obtain immediate financing. Factoring typically involves the purchase of credit-worthy accounts receivable at a small discount by a factoring company, which allows a business to obtain immediate cash flow.[1] A factor may, however, provide immediate cash against an L/C obligation as well. What possible risks might there be for the factoring company in an L/C factoring situation, as compared with the conventional purchase of accounts receivable?

f. Other Uses of the Letter of Credit

L/Cs come in two basic varieties, commercial (or "documentary" or "trade") L/Cs, and standby (or "guaranty") L/Cs. Despite apparent similarities, these two types perform quite different functions. As we have seen in the cases excerpted in § A.1.e, *supra*, the commercial L/C is most often used to finance commercial contracts for the shipment of goods from seller to buyer. It provides for prompt and reliable payment to the seller when shipment is made as specified under its terms.

The standby L/C certainly can be used in connection with a commercial transaction, but it is not linked directly to shipment of goods. It is usually used to cover performance of a service contract, to give assurance to a bank that the seller will honor his or her obligations under warranties, or to cover performance of a financial obligation (*e.g.*, an L/C may be used to guarantee payment of commercial paper at maturity). The role of the bank issuing standby L/Cs differs from its role in issuing commercial L/Cs. In § A.2.b, *infra*, we shall have occasion to examine these differences and the potential problems that standby L/Cs raise for banks participating in the international market for financial services.

2. Banking Aspects of Trade in Goods and Services[2]

So far, the discussion has not explained how payment is actually made in a trade transaction involving the sale of goods; neither has it faced the special problems of a trade transaction priced in a currency foreign to the seller or the buyer. In concept, both are relatively simple; in practice, dealing with large numbers of transactions, with increasingly electronic means, naturally becomes more complex. In addition, we have not mentioned the complexities of dealing in services like banking internationally. In this section, we shall highlight some of these issues.[3]

a. The Payment Mechanism

The payment mechanism, as well as the mutual confidence of banks, depends heavily on a network of reciprocal deposits. Groups of correspondent banks typically collaborate by maintaining such deposits and also exchange market and credit

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1. *See* Marsha E. Simms & Allison R. Liff, *Introduction to Secured Lending and Commercial Finance*, 839 PLI/Comm. 9, 43-47 (2002) (discussing factoring); Emmanuel T. Laryea, *Payment for Paperless Trade: Are There Viable Alternatives to the Documentary Credit?*, 33 Law & Pol'y Int'l Bus. 3 (2001) (contrasting documentary credit and factoring as methods of payment).

2. Much of the discussion in this section is drawn from Michael P. Malloy, Banking in the Twenty-First Century (Carolina Academic Press 2006). Used with permission.

3. *See also* Chapter XIV, *infra* (discussing rules governing trade in services).

information. These deposits or accounts permit easy transfer of funds.

Suppose that in the example developed in pp. ■■-■■, *supra*, Tokyo Bank and Chicago Bank each maintains a sizable dollar deposit with the other. Chicago Bank can now transfer money to the Tokyo exporter simply by sending a draft or a cable transfer (essentially an electronic analogue of a draft) to Tokyo Bank directing that bank to debit (take money from) Chicago Bank's account and credit (put money in) the exporter's account. This works exactly like a check directing payment out of one's own account. In international banking parlance, Chicago Bank will call its Tokyo account a *nostro* account ("our account with you"). As an alternative, Tokyo Bank's Chicago or *vostro* account ("your account with us," as seen from Chicago Bank's viewpoint) can be used instead. Chicago Bank credits this account with the payment and notifies Tokyo Bank, which can now pay the exporter with its own funds and end up exactly even. For a description of these transfers, see *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*, 609 F.2d 1047 (2d Cir. 1979), especially footnote 1.

Of course, the banks with whom the exporter and importer deal may not maintain a correspondent relation, but can still negotiate a draft through a series of banks that do maintain such relations. This is similar to the check-clearing concept in domestic practice. As a simple example, the transfer may be made through a third bank with whom both parties maintain relations: Australian Bank directs London Bank, with which it has an account, to pay Bahrain Bank, which also has a London account. Only rarely, if ever, is it necessary for currency actually to be shipped from place to place.

There is an important emerging body of law governing these wire transfers. A new article 4A of the Uniform Commercial Code was approved by the National Conference of Commissioners in 1989 and has been adopted by nearly all states. And UNCITRAL has drafted a new United Nations Model law on the subject, published in U.N. GAOR, 47th Sess., Supp. No. 17, Annex 1, at 48, U.N. Doc. A/47/17 (1992).

As suggested above, mutual deposits also provide a basis for banking confidence in the letter of credit. The letter of credit cases that we have already examined show that banks are quite eager to maintain their reputation; if a bank fails, however, its eagerness to honor its reputation is not enough. A bank, say in New York, can nevertheless recommend faith in a foreign bank's letters of credit if that bank has accounts in New York sufficient to cover the net obligations the foreign bank has outstanding on letters of credit to New York. The deposit serves as a sort of guarantee of payment, not very different from the deposit underlying a checking account. The international banks run daily balances of their relations with all major foreign banks, looking for risks arising from individual banks as well as from individual nations that might face a foreign exchange crisis.

More and more, today, the full transaction is being conducted in electronic form. The letter of credit can easily be sent in electronic form. As noted above, by using various authentication procedures, an electronic bill of lading can be sent in such a way that only one recipient gains the right to title. And the settlement can be through a wireless transfer.

The final issue to add to the routine trade transaction is that of foreign currency. A London buyer almost certainly wants to pay in sterling, while a U.S. seller wants to be paid in dollars. The contract of sale will have specified a currency and the drafts and letter of credit will almost certainly use (or, "be denominated in") the same currency. Under the assumption that that currency is the U.S. dollar, London Bank will have to pay dollars while receiving payment from its customer in sterling. It will do so by going into the foreign exchange market–a telephone-based market to bring together those who

wish to buy or sell foreign currency. In theory, the bank will find an individual (or another bank or other institution) who wishes to sell dollars and buy pounds and negotiate a price. That price will be charged to its clients along with a transaction fee. In practice, the bank will follow daily market quotations in dealing with its client, will net out its own purchases and sales of specific currencies, and will enter the market to maintain or reach a desired overall balance of currency holdings.

The foreign trade transaction offers significant flexibility in dealing with currencies. Most of the examples used so far have involved transactions in dollars. But a transaction could easily be denominated in sterling and payment made to a New York bank (for a U.S. export) in that currency. That bank would then go into the New York foreign exchange market to obtain dollars and its customer would be the one immediately paying the conversion. If there is credit involved, the possible differences between sterling and dollar interest rates may affect the parties' choice of transaction format, as between, say a draft denominated in dollars and one denominated in pounds.

The foreign exchange market operates like any other in that prices shift to clear the market. As a very rough approximation, this means that a nation that is exporting more than it is importing and therefore running a balance-of-trade surplus will see the price of its currency rise as foreign purchasers compete to obtain the quantities needed to pay for their purchases. (Note that currency quotation figures are sometimes confusing. The dollar is rising if one dollar buys 50 pence instead of 40; but this can also be expressed as saying the dollar has *risen* from US$2.50=£1 to US$2.00=£1.) This price rise will generally cause the nation's exports to appear more expensive and be less competitive abroad. The nation will tend to sell less, thus restoring balance in the market.

The real world is not quite so simple, with capital flow, speculative, and political factors as well as trade-derived factors affecting the market. On the capital flow side, investors will seek to put their funds where interest rates are highest, making allowance of course for their expectations of changes in the relative currency prices. On the speculative side, investors will tend to invest in those currencies that they expect will rise. And most governments intervene in the foreign exchange market for economic and political reasons.

Moreover, the effect of currency price changes on exports and imports is less clear than one might expect. In general, as a nation's currency inflates, the competitiveness of its exports falls, and the competitiveness of foreign imports rises. These changes will tend to restore balance. But there is usually a significant time lag during which contracts that were made at the old exchange rate have still to be performed. Moreover, the cost of production of some exports may depend highly on the prices of imports, which will also be affected by an exchange rate change. In addition, some commodities are priced in currencies that may not be affected by the currency adjustment; almost all international oil transactions, for example, are priced in dollars, no matter what nations are involved.

b. Bank Regulatory Aspects of L/C Transactions

As we have seen in § A.1.e, the L/C is primarily governed by transactional rules, embodied in Article 5 of the Uniform Commercial Code,[4] and, for certain international L/Cs, the International Chamber of Commerce's Uniform Customs and Practices for

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4. Uniform Commercial Code, art. 5 (1962, as amended 1990) or revised art. 5 (as amended 1995).

Documentary Credits[5] or other applicable international rules.[6] There is, however, a regulatory dimension to these instruments.

For example, under the regulations of the Comptroller of the Currency (the Treasury official who supervises national banks), a national bank is not permitted to make its obligation to pay under an L/C to be dependent "upon nondocumentary conditions or resolution of questions of fact."[7] Presumably, a national bank would therefore still be prohibited from performing a factual inspection of goods that were the subject of the transaction for which the letter of credit was issued.[8]

National banks now have the general authority to issue, confirm or otherwise undertake to honor or purchase L/Cs and other independent undertakings within the scope of the applicable transactional laws or rules of practice recognized by law.[9] The bank's obligation to honor depends upon the presentation of specified documents and not upon nondocumentary conditions or resolution of questions of fact or law at issue between the account party and the beneficiary.[10] More than the transactional law, the regulations focus primarily on the safety and soundness considerations involved in a bank's involvement in L/C.[11] These considerations are illustrated in Figure 2-4, *infra*.

One could argue that documentary L/Cs are simply a peculiar form of secured lending. For the brief time that the bank has accepted the documents and paid the beneficiary's draft but has not yet been reimbursed by the account party, there is something not unlike a collateralized loan relationship between the bank and its account party. On the other hand, the L/C is also a payment transfer mechanism. The best approach, of course, may be simply to consider the L/C on its own terms.

c. Treatment of Standby L/Cs

But are those terms the same regardless of whether we are considering a documentary L/C or a standby L/C? In fact, standby L/Cs raise quite distinct issues not relevant to documentary L/Cs. One of the basic regulatory issues, therefore, is whether or not the two should be subject to distinct regulatory regimes.

For example, in U.S. banking practice, foreign branches of U.S. banks are authorized to issue guarantees of the financial obligations of third parties, to the extent that local banks are so authorized.[12] U.S.-based banks are not permitted to issue guarantees, but they do issue standby L/Cs instead. Should its functional equivalence to a third-party guarantee make the standby L/C an impermissible transaction for U.S.-based banks? Consider the following excerpt.

HENRY HARFIELD, LEGALITY OF GUARANTY

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5. Uniform Customs and Practice for Documentary Credits (International Chamber of Commerce, Publication No. 500). *See Bank of Cochin Ltd. v. Manufacturers Hanover Trust*, 612 F. Supp. 1533 (S.D.N.Y. 1985) (discussing Uniform Customs and Practices).

6. United Nations Commission on International Trade Law ("UNCITRAL"), Convention on Independent Guarantees and Standby Letters of Credit (adopted by UNCITRAL 1995); Uniform Rules for Bank-to-Bank Reimbursements Under Documentary Credits (International Chamber of Commerce, Publication No. 525).

7. 12 C.F.R. § 7.1016(a).

8. *Cf. Maurice O'Meara Co., supra* (so holding under common law).

9. 12 C.F.R. § 7.1016(a).

10. *Id*.

11. 12 C.F.R. § 7.1016(b).

12. *See, e.g.*, 12 C.F.R. § 211.4(a)(1) (setting forth Federal Reserve rule for foreign branches).

LETTERS OF CREDIT

[1974 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 96,301 (July 1, 1974)

. . . I am in agreement with the proposition that the issuance and management of [standby L/Cs] should be regulated in the interest of prudent banking and the exercise of sound judgment. . . .

A *standby letter of credit* . . . is clearly a financing mechanism rather than a payment mechanism. Such credits, *i.e.*, those used to guarantee commercial paper, are *ab initio*, integral parts of a financing transaction. The sole purpose of issuing the credit is to assist the bank's customer in borrowing money, and as the sole condition upon which the bank must pay under the credit is the customer's default in repaying borrowed money, it is evident that the net effect is to substitute the bank for the holder of the commercial paper as a creditor of the bank's customer. . . .

The standby letter of credit . . . should properly be characterized as a letter of credit incidental to a financial transaction designed to assure that borrowed money will be repaid, rather than to assure payment for goods, services, or other values. . . .

The fact that such instruments are intended to and do serve the purpose of guaranties is completely immaterial. Every letter of credit, including those that facilitate a sale of goods or merchandise, has the attributes of a guaranty and some of the earliest forms of letters of credit in use in the United States were explicitly characterized as guaranties. *See, e.g., Omaha National v. First National of St. Paul*, 39 Ill. 428 (1871). . . .

A letter of credit engages the direct and primary liability of the bank, whereas the liability imposed by a guaranty or surety bond is secondary. . . .

This distinction is more than formal. A bank's liability under a letter of credit is dependent upon performance of the terms and conditions stated in the letter of credit, without reference to any other contract, agreement, or arrangement. Liability under a guaranty or surety bond, on the other hand, is dependent upon a determination as to whether an extraneous contract, agreement or arrangement has been performed in accordance with its own terms. . . .

A letter of credit, then, whether it be incidental to a commercial transaction or a financial transaction, is a lawful exercise of a national bank's power to conduct the business of banking. . . .

NOTE

As the next case illustrates, the standby L/C performs quite a different role from that of the documentary L/C. It serves to guarantee a service provider's performance rather than a buyer's payment. Many Mideast countries have insisted that foreign contractors maintain such arrangements in force during the life of the service contract. This case is one of a number of similar cases arising out of the Iranian revolution.

AMERICAN BELL INT'L, INC. v. ISLAMIC REPUBLIC OF IRAN

474 F. Supp. 420 (S.D.N.Y. 1979)

MACMAHON, DISTRICT JUDGE.

Plaintiff American Bell International Inc. ("Bell") moves for a preliminary injunction . . . , enjoining defendant Manufacturers Hanover Trust Company ("Manufacturers") from making any payment under its Letter of Credit No. SC 170027 to defendants the Islamic Republic of Iran or Bank Iranshahr or their agents, instrumentalities, successors, employees and assigns. We held an evidentiary hearing and heard oral argument on August 3, 1979. The following facts appear from the evidence presented:

The action arises from the recent revolution in Iran and its impact upon contracts made with the ousted Imperial Government of Iran and upon banking arrangements incident to such contracts. Bell, a wholly-owned subsidiary of American Telephone & Telegraph Co. ("AT & T"), made a contract on July 23, 1978 (the "Contract") with the Imperial Government of Iran Ministry of War ("Imperial Government") to provide consulting services and equipment to the Imperial Government as part of a program to improve Iran's international communications system.

The contract provides a complex mechanism for payment to Bell totalling approximately $280,000,000, including a down payment of $38,800,000. The Imperial Government had the right to demand return of the down payment at any time. The amount so callable, however, was to be reduced by 20% of the amounts invoiced by Bell to which the Imperial Government did not object. Bell's liability for return of the down payment was reduced by application of this mechanism as the Contract was performed, with the result that approximately $30,200,000 of the down payment now remains callable.

In order to secure the return of the down payment on demand, Bell was required to establish an unconditional and irrevocable Letter of Guaranty, to be issued by Bank Iranshahr in the amount of $38,800,000 in favor of the Imperial Government. The Contract provides that it is to be governed by the laws of Iran and that all disputes arising under it are to be resolved by the Iranian courts.

Bell obtained a Letter of Guaranty from Bank Iranshahr. In turn, as required by Bank Iranshahr, Bell obtained a standby Letter of Credit, No. SC 170027, issued by Manufacturers in favor of Bank Iranshahr in the amount of $38,800,000 to secure reimbursement to Bank Iranshahr should it be required to pay the Imperial Government under its Letter of Guaranty.

The standby Letter of Credit provided for payment by Manufacturers to Bank Iranshahr upon receipt of:

> "Your [Bank Iranshahr's] dated statement purportedly signed by an officer indicating name and title or your Tested Telex Reading: (A) 'Referring Manufacturers Hanover Trust Co. Credit No. SC170027, the amount of our claim $ represents funds due us as we have received a written request from the Imperial Government of Iran Ministry of War to pay them the sum of ___ under our Guarantee No. issued for the account of American Bell International Inc. covering advance payment under Contract No. 138 dated July 23, 1978 and such payment has been made by us' . . . ."

In the application for the Letter of Credit, Bell agreed--guaranteed by AT&T--immediately to reimburse Manufacturers for all amounts paid by Manufacturers to Bank Iranshahr pursuant to the Letter of Credit.

Bell commenced performance of its Contract with the Imperial Government. It provided certain services and equipment to update Iran's communications system and submitted a number of invoices, some of which were paid.

In late 1978 and early 1979, Iran was wreaked with revolutionary turmoil culminating

in the overthrow of the Iranian government and its replacement by the Islamic Republic. In the wake of this upheaval, Bell was left with substantial unpaid invoices and claims under the Contract and ceased its performance in January 1979. Bell claims that the Contract was breached by the Imperial Government, as well as repudiated by the Islamic Republic, in that it is owed substantial sums for services rendered under the Contract and its termination provisions.

On February 16, 1979, before a demand had been made by Bank Iranshahr for payment under the Letter of Credit, Bell and AT&T brought an action against Manufacturers in the Supreme Court, New York County, seeking a preliminary injunction prohibiting Manufacturers from honoring any demand for payment under the Letter of Credit. The motion for a preliminary injunction was denied in a thorough opinion by Justice Dontzin on March 26, 1979, and the denial was unanimously affirmed on appeal by the Appellate Division, First Department.

On July 25 and 29, 1979, Manufacturers received demands by Tested Telex from Bank Iranshahr for payment of $30,220,724 under the Letter of Credit, the remaining balance of the down payment. Asserting that the demand did not conform with the Letter of Credit, Manufacturers declined payment and so informed Bank Iranshahr. Informed of this, Bell responded by filing this action and an application by way of order to show cause for a temporary restraining order bringing on this motion for a preliminary injunction. Following argument, we granted a temporary restraining order on July 29 enjoining Manufacturers from making any payment to Bank Iranshahr until forty-eight hours after Manufacturers notified Bell of the receipt of a conforming demand, and this order has been extended pending decision of this motion.

On August 1, 1979, Manufacturers notified Bell that it had received a confon-ning demand from Bank Iranshahr. At the request of the parties, the court held an evidentiary hearing on August 3 on this motion for a preliminary injunction.

Criteria For Preliminary Injunctions

The current criteria in this circuit for determining whether to grant the extraordinary remedy of a preliminary injunction are set forth in *Caulfield v. Board of Education*, 583 F.2d 605, 610 (2d Cir. 1978):

> [T]here must be a showing of possible irreparable injury and either (1) probable success on the merits or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the party requesting the preliminary relief.

We are not persuaded that the plaintiff has met the criteria and therefore deny the motion.

A. Irreparable Injury

Plaintiff has failed to show that irreparable injury may possibly ensue if a preliminary injunction is denied. Bell does not even claim, much less show, that it lacks an adequate remedy at law if Manufacturers makes a payment to Bank Iranshahr in violation of the Letter of Credit. It is too clear for argument that a suit for money damages could be based on any such violation, and surely Manufacturers would be able to pay any money judgment against it.

Bell falls back on a contention that it is without any effective remedy unless it can restrain payment. This contention is based on the fact that it agreed to be bound by the laws of Iran and to submit resolution of any disputes under the Contract to the courts of Iran. Bell claims that it now has no meaningful access to those courts.

There is credible evidence that the Islamic Republic is xenophobic and anti-American and that it has no regard for consulting service contracts such as the one here. Although Bell has made no effort to invoke the aid of the Iranian courts, we think the current situation in Iran, as shown by the evidence, warrants the conclusion that an attempt by Bell to resort to those courts would be futile. . . . However, Bell has not demonstrated that it is without adequate remedy in this court against the Iranian defendants under the Sovereign Immunity Act which it invokes in this very case. 28 U.S.C. §§1605(a)(2), 1610(b)(2) (Supp. 1979).

Accordingly, we conclude that Bell has failed to demonstrate irreparable injury.

B. Probable Success on the Merits

Even assuming that plaintiff has shown possible irreparable injury, it has failed to show probable success on the merits. *Caulfield*, *supra*, at 610.

In order to succeed on the merits, Bell must prove, by a preponderance of the evidence, that either (1) a demand for payment of the Manufacturers Letter of Credit conforming to the terms of that Letter has not yet been made, . . . or (2) a demand, even though in conformity, should not be honored because of fraud in the transaction, *see, e.g.*, N.Y. UCC §5-114(2); *United Bank* [*supra*, p.■■]. It is not probable, in the sense of a greater than 50% likelihood, that Bell will be able to prove either nonconformity or fraud.

As to nonconformity, the August 1 demand by Bank Iranshahr is identical to the terms of the Manufacturers Letter of Credit in every respect except one: it names as payee the "Government of Iran Ministry of Defense, Successor to the Imperial Government of Iran Ministry of War" rather than the "Imperial Government of Iran Ministry of War." . . . It is, of course, a bedrock principle of letter of credit law that a demand must strictly comply with the letter in order to justify payment. . . . Nevertheless, we deem it less than probable that a court, upon a full trial, would find nonconformity in the instant case. . . .

If conformity is established, as here, the issuer of an irrevocable, unconditional letter of credit, such as Manufacturers normally has an absolute duty to transfer the requisite funds. This duty is wholly independent of the underlying contractual relationship that gives rise to the letter of credit. . . . Nevertheless, both the Uniform Commercial Code of New York, which the parties concede governs here, and the courts state that payment is enjoinable where a germane document is forged or fraudulent or there is "fraud in the transaction." N.Y. UCC §5-114(2); *United Bank* [*supra*]. Bell does not contend that any documents are fraudulent by virtue of misstatements or omissions. Instead, it argues there is "fraud in the transaction."

The parties disagree over the scope to be given as a matter of law to the term "transaction." Manufacturers, citing voluminous authorities, argues that the term refers only to the Letter of Credit transaction, not to the underlying commercial transaction or to the totality of dealings among the banks, the Iranian government and Bell. On this view of the law, Bell must fail to establish a probability of success, for it does not claim that the Imperial Government or Bank Iranshahr induced Manufacturers to extend the Letter by lies or half-truths, that the Letter contained any false representations by the Imperial Government or Bank Iranshahr, or that they intended misdeeds with it. Nor does Bell claim that the demand contains any misstatements.

Bell argues, citing equally voluminous authorities, that the term "transaction" refers to the totality of circumstances. On this view, Bell has some chance of success on the merits, for a court can consider Bell's allegations that the Government of Iran's behavior in connection with the consulting contract suffices to make its demand on the Letter of

Guaranty fraudulent and that the ensuing demand on the Letter of Credit by Bank Iranshahr is tainted with the fraud.

There is some question whether these divergent understandings of the law are wholly incompatible since it would seem impossible to keep the Letter of Credit transaction conceptually distinct. A demand which facially conforms to the Letter of Credit and which contains no misstatements may, nevertheless, be considered fraudulent if made with the goal of mulcting the party who caused the Letter of Credit to be issued. Be that as it may, we need not decide this thorny issue of law. For, even on the construction most favorable to Bell, we find that success on the merits is not probable. Many of the facts alleged, even if proven, would not constitute fraud. As to others, the proof is insufficient to indicate a probability of success on the merits.

Bell, while never delineating with precision the contours of the purported fraud, sets forth five contentions which, in its view, support the issuance of an injunction. Bell asserts that (1) both the old and new Governments failed to approve invoices for services fully performed; (2) both failed to fund contracted-for independent Letters of Credit in Bell's favor; (3) the new Government has taken steps to renounce altogether its obligations under the Contract; (4) the new Government has made it impossible to assert contract rights in Iranian courts; and (5) the new Government has caused Bank Iranshahr to demand payment on the Manufacturers Letter of Credit, thus asserting rights in a transaction it has otherwise repudiated. . . . Even if we accept the proposition that the evidence does show repudiation, plaintiff is still far from demonstrating the kind of evil intent necessary to support a claim of fraud. Surely, plaintiff cannot contend that every party who breaches or repudiates his contract is for that reason culpable of fraud. The law of contract damages is adequate to repay the economic harm caused by repudiation, and the law presumes that one who repudiates has done so because of a calculation that such damages are cheaper than performance. Absent any showing that Iran would refuse to pay damages upon a contract action here or in Iran, much less a showing that Bell has even attempted to obtain such a remedy, the evidence is ambivalent as to whether the purported repudiation results from non-fraudulent economic calculation or from fraudulent intent to mulct Bell.

Plaintiff contends that the alleged repudiation, viewed in connection with its demand for payment on the Letter of Credit, supplies the basis from which only one inference–fraud–can be drawn. Again, we remain unpersuaded.

Plaintiff's argument requires us to presume bad faith on the part of the Iranian government. It requires us further to hold that that government may not rely on the plain terms of the consulting contract and the Letter of Credit arrangements with Bank Iranshahr and Manufacturers providing for immediate repayment of the down payment upon demand, without regard to cause. On the evidence before us, fraud is no more inferable than an economically rational decision by the government to recoup its down payment, as it is entitled to do under the consulting contract and still dispute its liabilities under that Contract.

While fraud in the transaction is doubtless a possibility, plaintiff has not shown it to be a probability and thus fails to satisfy this branch of the *Caulfield* test.

C. Serious Questions And Balance of Hardships

If plaintiff fails to demonstrate probable success, he may still obtain relief by showing, in addition to the possibility of irreparable injury, both (1) sufficiently serious questions going to the merits to make them a fair ground for litigation, and (2) a balance of hardships tipping decidedly toward plaintiff. *Caulfield*, *supra*. Both Bell and Manufacturers appear to concede the existence of serious questions, and the complexity

and novelty of this matter lead us to find they exist. Nevertheless, we hold that plaintiff is not entitled to relief under this branch of the *Caulfield* test because the balance of hardships does not *tip decidedly* toward Bell, if indeed it tips that way at all.

To be sure, Bell faces substantial hardships upon denial of its motion. Should Manufacturers pay the demand, Bell will immediately become liable to Manufacturers for $30.2 million, with no assurance of recouping those funds from Iran for the services performed. While counsel represented in graphic detail the other losses Bell faces at the hands of the current Iranian government, these would flow regardless of whether we ordered the relief sought. The hardship imposed from a denial of relief is limited to the admittedly substantial sum of $30.2 million.

But Manufacturers would face at least as great a loss, and perhaps a greater one, were we to grant relief. Upon Manufacturers' failure to pay, Bank Iranshahr could initiate a suit on the Letter of Credit and attach $30.2 million of Manufacturers' assets in Iran. In addition, it could seek to hold Manufacturers liable for consequential damages beyond that sum resulting from the failure to make timely payment. Finally, there is no guarantee that Bank Iranshahr or the Government, in retaliation for Manufacturers' recalcitrance, will not nationalize additional Manufacturers' assets in Iran in amounts which counsel, at oral argument, represented to be far in excess of the amount in controversy here.

Apart from a greater monetary exposure flowing from an adverse decision, Manufacturers faces a loss of credibility in the international banking community that could result from its failure to make good on a letter of credit.

Conclusion

Finally, apart from questions of relative hardship and the specific criteria of the *Caulfield* test, general considerations of equity counsel us to deny the motion for injunctive relief Bell, a sophisticated multinational enterprise well advised by competent counsel, entered into these arrangements with its corporate eyes open. It knowingly and voluntarily signed a contract allowing the Iranian government to recoup its down payment on demand, without regard to cause. It caused Manufacturers to enter into an arrangement whereby Manufacturers became obligated to pay Bank Iranshahr the unamortized down payment balance upon receipt of conforming documents, again without regard to cause.

Both of these arrangements redounded tangibly to the benefit of Bell. The Contract with Iran, with its prospect of designing and installing from scratch a nationwide and international communications system, was certain to bring to Bell both monetary profit and prestige and good will in the global communications industry. The agreement to indemnify Manufacturers on its Letter of Credit provided the means by which these benefits could be achieved.

One who reaps the rewards of commercial arrangements must also accept their burdens. One such burden in this case, voluntarily accepted by Bell, was the risk that demand might be made without cause on the funds constituting the down payment. To be sure, the sequence of events that led up to that demand may well have been unforeseeable when the contracts were signed. To this extent, both Bell and Manufacturers have been made the unwitting and innocent victims of tumultuous events beyond their control. But, as between two innocents, the party who undertakes by contract the risk of political uncertainty and governmental caprice must bear the consequences when the risk comes home to roost.

Manufacturers also contends that, in view of the action apparently still pending in the state courts, we should abstain from deciding the issues before us and that Bell is

engaging in forum-shopping which dirties its hands so as to require a denial of injunctive relief. In view of our findings and conclusions based on the *Caulfield* test, we find it unnecessary to consider these contentions. . . .

Accordingly, plaintiff's motion for a preliminary injunction . . . is denied. However, Manufacturers Hanover Trust Company, its officers and agents are hereby enjoined from making any payments to Bank Iranshahr or the Islamic Republic of Iran, pursuant to the subject Letter of Credit, until August 6, 1979, at 3:00 p.m. to permit plaintiff to apply to the Court of Appeals for a stay pending appeal, if it is so advised.

NOTES AND QUESTIONS

1. In cases like *American Bell International*, courts are essentially invoking generally applicable principles developed in the commercial L/C context to instruments that, despite their name, are significantly different from traditional commercial L/Cs, and that are more like third-party guarantees. In this regard, consider the effect on a "fraud in the transaction" claim.[1] In the case of a documentary L/C,[2] the stringencies of the "fraud in the transaction" theory can be straightforwardly met by simple facts–have the goods been shipped, or do the boxes contain trash? Do these requirements work out satisfactorily when we are really arguing about the good faith of an undocumented demand under a standby L/C, rather than a documented demand? At least in the case of the documented demand, we can assume that there are some goods floating around to secure the bank's risk.

2. As the U.S.-Iran crisis of 1979 worsened, however, there were at least some indications that courts were beginning to consider the plight of account parties to standby letters of credit (and their issuing banks) in a more thoughtful fashion.[3] Eventually, of course, the U.S. Government would intervene and freeze the standby letters of credit, so that potentially fraudulent demands could not be effected.[4] This development means that we lack any definitive judicial resolution of the problem of adapting rules that arose in the documentary letter of credit context to the standby letter of credit context.

3. What commercial purposes did the L/C in *American Bell* serve? How are they different from those of documentary L/Cs in the usual export/import transaction? For related cases and materials, see *Harris Corp. v. National Iranian Radio and Television*, 691 F.2d 1344 (llth Cir. 1982); *KMW International v. Chase Manhattan Bank*, 606 F.2d 10 (2d Cir. 1979); *R. D. Harbottle (Mercantile) Ltd. v. National Westminster Bank*, [1977] 2 All ER. 862; Michael P. Malloy, *The Iran Crisis: Law Under Pressure*, 1984 Wisc. Int'l L.J. 15 (1984) (discussing standby L/C problem).

4. *American Bell International* implicitly rejects the suggestion that more refined rules should be applied in the case of standby L/Cs. The result is an outcome that, intuitively, seems to be contrary and unsatisfying. Judge MacMahon's opinion notwithstanding, there are some significant differences between commercial and standby

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1. Uniform Commercial Code, § 5-114(2); Uniform Commercial Code, § 5-109(b) (1995 Rev.).

2. See, e.g., *United Bank Ltd., supra*, at ▬ (involving "fraud in the transaction" claim where mildewed goods had been shipped on a cancelled contract).

3. *See, e.g., Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (S.D.N.Y. 1979) (finding serious risk of fraudulent or nonauthentic demand sufficient showing for preliminary injunction against payment under standby letter).

4. *See* Michael P. Malloy, *The Iran Crisis: Law Under Pressure*, 1984 Wisc. Int'l L.J. 15 (1984) (discussing standby L/C policy under 31 C.F.R. pt. 535 (1980)).

L/Cs. Figure 2.5, *infra*, illustrates the fundamental differences in the respective structure and assumptions of the documentary L/C and the standby L/C transactions. In light of these differences, does it make sense to treat them indistinguishably?

B. EXPORT CREDIT ARRANGEMENTS

The letter of credit mechanism works well for exports to nations with relatively easy access to funds. Although the seller can easily extend short-term credit to the buyer, the latter must be able to pay within a few months. It is obviously difficult for private agencies in the exporting nation to extend long-term credit to the buyer when the goods, as the obvious collateral, are in another nation. In part for this reason, which restricts the ability of the regular banking system to help with sales to the developing world, but far more out of a desire to maintain exports and the consequent employment, most developed world governments have instituted a government export financing system. For background, *see* Duff, *The Outlook for Official Export Credits*, 13 Law & Poly. Intl. Bus. 891(1981).[1]

1. The United States Version

The U.S. example is the Export-Import Bank (Eximbank), described in the following excerpt from its own literature. This independent agency has a variety of programs for providing credit for exports of goods and services. In some cases, it is itself the lender; in others, it guarantees a loan to make it easier for private lenders to make the loan.

EX-IM BANK PROGRAMS – OVERVIEW

Export-Import Bank of the United States (June 2001)
available at www.exim.gov/mover

The Export-Import Bank of the United States (Ex-Im Bank) is an independent U.S. Government agency that helps finance the overseas sales of U.S. goods and services. In 65 years, Ex-Im Bank has supported more than $300 billion in U.S. exports. . . .

Ex-Im Bank's mission is to create jobs through exports. It provides guarantees of working capital loans for U.S. exporters, guarantees the repayment of loans or makes loans to foreign purchasers of U.S. goods and services. Ex-Im Banks also provides credit insurance that protects U.S. exporters against the risks of non-payment by foreign

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1. Another response to currency restrictions is for firms to barter internationally. There is also a fairly common process of countertrade, in which a firm agrees to make reciprocal purchases as a form of return for its sale. For information on barter, see B. Fisher & K. Harte (eds.), Barter in the World Economy (1985); R. DeMarines, Analysis of Recent Trends in U.S. Countertrade (U.S. International Trade Commission Pub. No. 1237, March 1982); Guyot, *Countertrade Contracts in International Business*, 20 Int'l Law. 921 (1986); Lochner, *Guide to Countertrade and International Barter*, 19 Int'l Law. 725 (1985); Ludlow, *A Guide to Barter in the China Trade*, 6 China Bus. Rev. 10-16, (1979); McVey, *Countertrade and Barter: Alternate Trade Financing by Third World Nations*, 6 Intl. Trade L.J. 197 (1980-1981); Nugent, *U.S. Countertrade Policy: Is it Economically Sound?*, 19 Geo. Wash. J. Int'l L. & Econ. 829 (1985); OECD, East-West Trade: Recent Developments in Countertrade (1981); Shillinglaw & Stein, *Doing Business in the Soviet Union*, 13 Law & Poly. Int'l Bus. 1 (1981); U.N. Economic Commission for Europe, International Buy-Back Contracts (Doc. ECE/TRADE/176, 1991); U.N. Economic Commission for Europe, International Counterpurchase Contracts (Doc. ECE/TRADE/169, 1990); P. Verzariu, Countertrade Practices in East Europe, the Soviet Union and China: An Introductory Guide to Business (Office of East-West Trade Development, Int'l Trade Admin., U.S. Department of Commerce, April, 1980); D. Vogt, *et al.*, Barter of Agricultural Commodities (U.S. Department of Agriculture, April, 1982). For one of the few litigated examples, see *Samincorp USA, Inc. v Republic of Guyana*, 1989 U.S. Dist LEXIS 5325 (SDNY 1989).

buyers for political or commercial reasons. Ex-Im Bank does not compete with commercial lenders, but assumes risks they cannot accept. It must always conclude that there is reasonable assurance of repayment on every transaction financed. . . .

Ex-Im Bank provides a level playing field for U.S. exporters by countering the export credit subsidies of other governments. It also provides financing for creditworthy private and sovereign foreign buyers when private financing is unavailable. To qualify for Ex-Im Bank support, the product or services must have at least 50 percent U.S. content and must not affect the U.S. economy adversely.

Ex-Im Bank supports the sales of U.S. exports worldwide. In recent years, its focus has shifted to the developing nations whose economies are growing at twice the rate of the industrial nations.

Ex-Im Bank will finance the export of all types of goods or services, including commodities, as long as they are not military-related (certain exceptions exist). Two of its major goals are to increase the export of environmental goods and services, which are in strong demand among the developing nations, and to expand the number of U.S. small businesses using Ex-Im Bank programs. . . .

Ex-Im Bank as a government agency operates under certain mandates, restrictions and requirements placed upon it by legislation and executive order. Major factors affecting Ex-Im Bank's participation in a transaction include consideration of the following:

U.S. Content	Ex-Im Bank's mission is to support U.S. jobs through exports. Accordingly, there are foreign content eligibility criteria and limitations on the level of foreign content that may be included in Ex-Im Bank's financing package. The total level of support for a supply contract will be the lesser of: • 85% of the value of all eligible goods and services in the U.S. supply contract; or • 100% of the U.S. content in all eligible goods and services in the U.S. supply contract. Note: To be eligible for Ex-Im Bank financing, goods and services in a U.S. supply contract must be shipped from the United States to a foreign buyer.
Small Business	Ex-Im Bank is mandated to 'set aside' 10 percent of its business for small businesses. The Bank accomplishes this in a variety of means including special small business programs.
Environmental Impact	Ex-Im Bank has a long history of environmental consideration. In the early 70's Ex-Im Bank reviewed the environmental impact of only large transactions
Environmental Enhancements	Today, almost all programs have some environmental considerations and enhancements.
MARAD[a]	Ex-Im Bank MARAD Requirements:
Public Resolution 17	Public Resolution 17 • For all direct loans & long-term guarantees, items must be shipped on U.S. bottoms, if not, they are ineligible for Ex-Im Bank support. A waiver from MARAD may be obtained. • Three Waiver Types: 1. General Waiver: up to 50% may be shipped on non-U.S. vessels. 2. Hardship Waiver: If no U.S. vessels are scheduled for destination. 3. Country Waiver: Brazil; applies to eligibility of shipping costs not

a. *I.e.*, the Maritime Administration of the Department of Transportation. For discussion of the role of the Department in the regulation of international trade, see Chapter III, *infra* at ▬.

	towards general waiver provision.
Service Sector	Ex-Im Bank treats services in an equal manner with commodities and manufactured goods. Several programs have been established to support the services industries including the Engineering Multiplier Program.[b]
Military Restriction	Ex-Im Bank is prohibited from financing military items. Ex-Im Bank will finance the export of any type of good or service, including commodities, as long as they are not military-related (certain exceptions exist).
Competitiveness (Additionality)	Ex-Im Bank is mandated to be 'competitive' with other export-finance agencies throughout the world. Ex-Im Bank is a member of the Organization for Economic Cooperation and Development (OECD). The OECD consists of a group of 24 nations represented by their treasury and export finance organizations to promote commonality of financing terms. Agreements, policies and resolution procedures have been promulgated in the following areas: 1. Cash Payment 4. Tied Aid 2. Repayment Terms 5. Interest Rates 3. Local Costs 6. Fees
Economic Impact	Ex-Im Bank must take the competitive position of U.S. industry into account in evaluating its transactions and must not support transactions which would be considered detrimental to the U.S. economy.
Used Equipment	Ex-Im Bank will finance used equipment which has been refurbished or reconstructed in the U.S. subject to: • Used Equipment Questinnaire is filled out; • Item cannot have been previously exported; • Usually Ex-Im support for shorter term.

Working Capital Guarantee Program

The Working Capital Guarantee Program is a pre-export financial tool to enable exporters to obtain necessary working capital in order to bid, construct or enhance production and complete foreign contract awards. Delegated authority is available to lenders enabling them to commit Ex-Im Bank's guarantee and to share in the fee income.[c]

Insurance Program

The Export Credit Insurance program helps U.S. exporters develop and expand their overseas sales by protecting them against loss should a foreign buyer or other foreign debtor default for political or commercial reasons.

To encourage the export of U.S. goods and services, Ex-Im Bank has tailored its policies to meet the insurance needs of exporters and financial institutions. For example, insurance policies may apply to shipments to one buyer or to many buyers, insure comprehensive (commercial and political) credit risks or only specific political risks, or cover short-term as well as medium-term sales. Three policies, the Small Business Policy, the Small Business Environmental Policy and the Umbrella Policy, are geared specifically to small businesses just beginning their export sales program. Eligibility criteria differ for each type of policy.

Medium- and Long-Term Loans and Guarantees

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b. Ex-Im Bank established this program to stimulate exports of U.S. architectural, industrial design, and engineering services, thus increasing the potential market for future U.S. exports in support of projects that might be constructed on the basis of designs developed by U.S. service firms.

c. On the group of enabled lenders, see discussion of Insurance Program, *infra*.

Medium- and Long-Term Loan Program

The medium- and long-term loan program is a foreign buyer credit program in which Ex-Im Bank establishes a credit and repayment schedule by concluding a credit agreement with a foreign buyer. Disbursements go to the U.S. exporter, and the export products go to the foreign buyer.

1. Loan = 85 percent of the U.S. export value.
2. Long-term financing available (over $10 million or greater than 7 year repayment term).
3. Medium-term financing available ($10 million or less and less than or equal to 7 year repayment term).
4. Ex-Im Bank fixed lending rates apply. . . .

Credit Guarantee or Financial Institutions (Bank) Facilities

Ex-Im Bank established the Credit Guarantee Facility Program from what was once known as 'bundling facilities'. The program was established to leverage Ex-Im Bank's resources and provide efficiencies by empowering financial institutions to 'collect' export transactions and have them underwritten in a grouped manner, in lieu of submitting every transaction separately for approval. . . .

Project Finance Program

Ex-Im Bank offers limited resource project finance support to assist U.S. exporters competing in international growth industries. For this program, many of Ex-Im Bank's financial and other requirements and considerations are specialized. Early involvement of and introductory meetings with Business Development are highly recommended. . .

Aircraft Finance Program

Ex-Im Bank will offer financial support for the export of new or used U.S. manufactured aircraft, including helicopters. Terms and conditions are generally governed by the OECD Sector Understanding on Export Credits for Civil Aircraft. Ex-Im Bank also offers asset-based commercial aircraft financing. . . .

Lease Coverage Program

Ex-Im Bank will guarantee financing for leases to foreign entities to help support U.S. exporters and foreign lessors of U.S.-manufactured equipment and related services. . . .

Tied Aid

The Tied-Aid Capital Projects Fund is a U.S. trade policy tool aimed at countering trade-distorting foreign tied aid offers[d] in selected environments. [The Fund is subject to OECD procedures, and it requires a determination of need and evidence of competitiveness] . . .

PEFCO

PEFCO is a group of commercial banks, industrial companies, and financial services companies which offer liquidity support for Ex-Im Bank guaranteed export transactions and the [Working Capital Guarantee Program].[e] . . .

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d. *I.e.*, offering export credits contingent on the purchase of national or specific goods.

e. On the Working Capital Guarantee Program, see *supra* at ▬.

NOTES AND QUESTIONS

1. Should an Ex-Im Bank insurance policy be interpreted in a technical way, so as to favor the government insurer, or in a more non-technical way, so as to favor the insured? *See Seattle Fur Exchange v. Foreign Credit Ins. Assn.*, 7 F.3d 158 (9th Cir. 1993) (applying relatively strict test to protect government insurer); *Enterprise Tools, Inc. v Export-Import Bank*, 799 F.2d 437 (8th Cir. 1986) (reading policy to exclude confiscation risk).

2. Why does Ex-Im Bank offer so many different programs? Consider the service-oriented issues of convenience for different kinds of users, the financial issues of conserving capital, as well as the political questions of maintaining relations with different parts of the financial community.

3. Aircraft exporters have usually been the largest single users of Ex-Im Bank funds. Foreign airlines are therefore able to fly aircraft purchased at a lower interest rate than are U.S. airlines. Is this unfair to the U.S. airlines? What kinds of remedies might be appropriate for a firm affected this way?

4. Would you recommend that Ex-Im Bank grant foreign-currency loans and guarantees? It decided to do so in 1980. When it honors a foreign currency guarantee and the exchange rate varies between the times of guarantee, default, and actual payment, which should be used? For consideration of this issue in the British context, see *Lucas v. Export Credits Guarantee Dept.*, 2 A.E.R. 889 (1974).

5. Is it wise to use Ex-Im Bank to offer relatively open-ended funding to nations in debt trouble to assist them in making purchases from the United States? (This program also started in the 1980s.)

6. Ex-Im Bank has been marked by scandal more than have most federal agencies. *See, e.g.*, Ann Crittenden, *The Imbroglio Over the Export-Import Bank*, N.Y. Times, Feb. 12, 1978, at C1, col. 1 (reporting on allegations of inadequate economic review and possible favoritism to specific suppliers in sale of nuclear reactor to Philippines). Why might this be?

7. Part of the economic argument against the Ex-Im Bank concept is that subsidies to some exports raise the value of the dollar and therefore penalize other exports. *See, e.g.*, Congressional Budget Office, *The Benefits and Costs of the Export-Import Bank Loan Subsidy Program*, in *Hearings Before the Subcommittee on International Trade, Investment and Monetary Policy of the House Committee on Banking, Finance, and Urban Affairs on Export-Import Bank Budget Authorization*, 97th Cong., Ist Sess. 1981. Exim's response to such criticism runs along the following lines:

> Eximbank . . . bases its rebuttal on the following two-step argument:
>
> (1) Foreign government export credit subsidies interfere with the market; international purchase decisions in certain capital goods sectors are not being based on market conditions, but rather on the extent to which another government will offer subsidized export credits.
>
> (2) By neutralizing the effect of these foreign subsidies, Eximbank allows the market to once again operate freely. With the availability of financing no longer a decision element, the foreign purchaser must make a decision based on market-determined factors.
>
> Hence, the fundamental economic rationale for a competitive Eximbank direct loan program is the benefit to the U.S. economy of allowing market forces to operate, which permits U.S. capital goods industries to achieve their "natural" level of output, including exports as well as domestic sales. This benefit prevents U.S. industrial resources from being continuously shifted from more efficient (market-determined) to less efficient

> (foreign-government-determined) uses--not vice versa. . . . By preventing such a shift, Exim credits help maintain the highest level of productivity possible, as presumably the market determines where resources can be used most productively.

Id. Do you think Ex-Im Bank's rebuttal is convincing? Given the economic arguments against Ex-Im Bank, why is it regularly renewed?

8. In June 2002, the Ex-Im Bank was reauthorized.[1] In addition to renewing the bank's authority until 2006,[2] the Reauthorization Act also makes the following major substantive changes in the bank's statutory powers.

(a) *Purposes of the Ex-Im Bank*. The act clarifies the statutory objects and purposes of the bank to include explicitly contributing "to maintaining or increasing employment of United States workers."[3]

(b) *Funding Authority*. Tto the extent that funding is provided from year to year in pertinent appropriation acts, the Reauthorization Act increases the dollar amounts of aggregate loan, guarantee, and insurance authority of the Ex-Im Bank.[4]

(c) *Outreach to Certain Small Businesses*. The act now requires "particular emphasis on conducting outreach and increasing loans to socially and economically disadvantaged small business concerns . . . , small business concerns . . . owned by women, and small business concerns . . . employing fewer than 100 employees."[5]

(d) *Tied Aid Credit Fund*. The act sharpens the principles, process, standards and procedures applicable to tied aid.[6] It also mandates further negotiations with the OECD over the OECD Export Credit Arrangement governing the use of credits, to enhance transparency of activities governed by the arrangement.[7] It also requires the Secretary of the Treasury to seek negotiations for an OECD arrangement on *untied* aid.[8] Specifically, the Secretary is supposed to "seek agreement on subjecting untied aid to the rules governing the Arrangement, including the rules governing disclosure."[9]

(e) *Application for Assistance Based on Fraud or Corruption*. The act gives express authorty to the Bank to deny any application for assistance if it has "substantial credible evidence that any party to the transaction or any party involved in the transaction has committed an act of fraud or corruption in connection with the transaction."[10]

(f) *Use of Ex-Im Bank Applications as Aid to Enforcement of other Trade-Related Laws*. The Reauthorization Act takes advantage of the application process as leverage for enforcement of other trade-related laws. For example, § 17 of the act to consider "a foreign nation's lack of cooperation in efforts to eradicate terrorism" in deciding on applications affecting such a country.[11] Likewise, § 18 of the act prohibits the bank from providing any loan or guarantee to an entity for production of substantially the same

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1. Export-Import Bank Reauthorization Act of 2002, Pub. L. No. 107-189, 116 Stat. 698 (2002) (codified at 5 U.S.C. App. 3 §§ 9(a)(2), 11(1)-(2), (5), 5315; 12 U.S.C. §§ 635(a)(1), (b)(1)(A), (b)(1)(B), (b)(1)(E)(iii)(II), (b)(1)(E)(v), (b)(1)(E)(x), (b)(1)(H)(ii)-(iii), (b)(1)(J)-(L), (b)(6)(D)(i)(III), (b)(6)(E), (b)(6)(H), (b)(6)(I)(i)(II), (b)(6)(I)(iii), (b)(9)(A), (b)(9)(B)(iii), (b)(12), (e)(2)-(4), (f), 635a(d)(2)(B), 635e(a), 635f, 635g(c)-(e), 635i-3(a)(4)-(6), (b)(2)(A), (b)(5), (b)(6), (g)(1), (h)(7), 635i-6(a)(1), 635i-8(a), 635i-9; 31 U.S.C. § 1105(a)) (Reauthorization Act).

2. Reauthorization Act § 3 (codified at 12 U.S.C. § 635f).

3. *Id*. § 2 (codified at 12 U.S.C. § 635(a)(1)).

4. *Id*. § 5 (codified at 12 U.S.C. § 635e(a)).

5. *Id*. § 7 (codified at 12 U.S.C. § 635(b)(1)(E)(iii)(II)).

6. *Id*. § 9 (codified at 12 U.S.C. § 635i-3(b)). On tied aid, see *supra* at 100.

7. Reauthorization Act § 10(b) (12 U.S.C. § 635i-9).

8. *Id*. § 10(a) (codified at 12 U.S.C. § 635a note).

9. *Id*. § 10(a)(1). *Cf. id.* § 10(c) (codified at 12 U.S.C. § 635i-3(a)) (mandating use of tied aid credit fund to combat untied aid by other countries).

10. *Id*. § 16 (codified at 12 U.S.C. § 635(f)).

11. 12 U.S.C. § 635(b)(1)(B).

product that is the subject of an antidumping order[12] or a countervailing duty order,[13] or an "escape clause" determination imposing duties in response to domestic industry injury from surges in fairly priced imports.[14] Section 18 also requires the bank to promulgate regulatory procedures regarding loans or guarantees provided to any entity that is subject to a *preliminary* determination of material injury to a domesti industry that *might* lead to an antidumping or countervailing duty.[15] Finally, under § 19 of the act, the bank must require an applicant "to disclose whether the applicant has been found by a court of the United States to have violated the Foreign Corrupt Practices Act of 1977, the Arms Export Control Act, the International Emergency Economic Powers Act, or the Export Administration Act of 1979 within the preceding 12 months, and shall maintain, in cooperation with the Department of Justice, for not less than 3 years a record of such applicants so found to have violated any such Act."[16]

2. International Responses

The United States is one of many nations with such export subsidy programs. Foreign programs are frequently much stronger in the sense of giving lower interest rates and a wider variety of services. This produces such bizarre situations as Great Britain loaning money to OPEC nations in order to be competitive in export terms. For broad, even if somewhat dated reviews of the programs, *see* OECD,The Export Credit Financing Systems in OECD Member Countries (1982); *UK Adapts Its Export Credit Programs to Keep Them Comprehensive, Flexible*, IMF Survey, July 3, 1978, at 194.

The response to this competition in credit terms has been to seek cartel-like agreement, partly to reduce the cost of the subsidies and partly to avoid the risk that this credit, like easy consumer credit in the domestic context, may encourage developing nations to spend beyond their means. The Berne Union, an organization of export credit granting agencies started in the 1930s, became more a data-exchange and credit-rating agency than a cartel.

By the 1970s, the OECD, an association of the leading developed nations, became the primary focus for negotiations on export credit terms, and a series of guidelines were developed. Negotiations, however, routinely faced failure in the marketplace as nations competed with one another for specific export opportunities. The United States even moved to a specific "Tied Aid Warchest" program within the Ex-Im Bank, to provide financing designed to match foreign competition. Nevertheless, agreements were regularly reached. The most important, the Helsinki Guidelines of 1992, prohibited tied aid credits to nations above a specified income level, and required a high grant component on such credits to lower income countries. For nations in between, tied aid credit was to be used only for projects that are not financially viable or cannot be financed on market terms and must include a moderate grant component. The Guidelines did not apply to sales to Eastern Europe. *See* Rosefsky, *Tied Aid Credits and the New OECD Agreement*, 14 U. Pa. J. Int'l Bus. L. 437 (1993); Moravcsik, *The OECD Export Credit Arrangement*, 43 Int'l Org. 174 (1989).

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12. On antidumping orders, see *infra* Chapter V.

13. On countervailing duties applicable to subsidized imports, see *infra* Chapter VI.

14. 12 U.S.C. § 635(e)(2)(A). On "escape clause determinations, see *infra* Chapter IV, § A.1.

15. 12 U.S.C. § 635(e)(2)(B).

16. *Id*. § 635(b)(1)(L). *See also id*. § 635(b)(1)(B) (requirig consideration of enforcement of certain laws). The statutes referred to in the quotation are discussed in Chapter XIII, *infra*.

NOTES AND QUESTIONS

1. Is it wise to give (or guarantee) easy export credit to developing nations at a time when these nations are having trouble paying bank debts?

2. Why aren't the GATT/WTO subsidy rules (to be discussed in Chapter VI) already an effective restriction on subsidized export credit? We shall explore the legal implications of this issue in Chapter VI, at ▬, *infra*. The practical answer to the question is that the subsidies rules are generally designed to protect the *importing* nation. The usual export credit problem, however, is that the importing nation is happy to receive the subsidy; competing exporters are the ones that are harmed--and there is no easy mechanism to protect them. For additional information on the issue of officially supported export credits, see G. Hufbauer and G. Erb, Subsidies in International Trade 68-76 (Washington, D.C.: Institute for International Economics, 1984).

C. THE LAW OF INTERNATIONAL INVESTMENT

The law of international investment is a polyglot of public and private law sources. This diverse collection includes principles drawn from international law–such as customary principles of public international law, multilateral treaties like the General Agreement on Trade in Services (GATS),[1] and bilateral investment treaties (BITs), domestic statutes and regulations–both those of the home country of the investor and those of the host country where the investment is placed–and regional rules, like the "supranational law" of the European Union[2] that is "directly applicable" and "directly effective" in its member states. While a variety of these sources may apply simultaneously to a given investment transaction or a type of investment, there is little in the way of careful coordination among these sources. Case by case, one is forced to sort out the implications of the applicable laws.[3]

In addition to the conceptual dissonance in the law of international investment, there is also a related temporal lag in this area of the law that must be factored into our analysis. In other words, different elements of the law of international investment emerged at very distinct historical moments and have developed at markedly different rates over time. Thus, the largely customary international law of nationalization and expropriation developed relatively early, but appears to have largely stalled out during the late 1960s and 1970s.[4] However, since no body of legal principles has definitively replaced the traditional law, it remains potentially applicable to modern situations.[5]

Often the legal context of a particular investment will be significantly modified by an applicable foreign investment code enacted by the host country; as many such codes

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1. On the GATS, see Chapter III, *infra* at ▬.

2. On the European Union, see *id*. at ▬.

3. As one commentator has noted, "[a] multilateral instrument dealing with international investment would clearly fill a large gap in the network of regulatory measures governing the world economy." Sol Picciotto, *Linkages in International Investment Regulation: The Antinomies of The Draft Multilateral Agreement on Investment*, 19 U. Pa. J. Int'l Econ. L. 731, 732 (1998). The OECD formally initiated negotiations on a proposed Multilateral Agreement on Investment (MAI) in 1995. By May 1998, it had failed to produce a final draft, and despite informal consultations among senior officials in October and December 1998, the OECD announced on 4 December 1998 that MAI negotiations were no longer taking place. OECD, *Informal Consultations on International Investment*, SG/COM/NEWS(98)114.

4. For a work devoted mainly to analysis of the law of nationalization and expropriation, see M. Sornarajah, The International Law on Foreign Investment (1994).

5. *See, e.g., Texas Overseas Petroleum Co. v. Libyan Arab Republic* (1977), *reprinted in*, 17 Int'l Leg. Mat. 1 (1978) (applying traditional international rules concerning expropriation, in absence of consensus on superseding rules).

were enacted during the 1980s and 1990s. As a practical matter, despite the existence of the customary law of nationalization and expropriation, "it is unlikely that states will embark upon wholesale programmes of nationalization. The trend is to attract rather than drive away foreign investment."[6] This trend has been given even greater momentum by the growing movement towards privatization of state-owned enterprises (often through foreign direct investment (FDI)[7]) in many developing countries and in emerging economies in the former Soviet bloc.[8] On the other hand, as increasing competition for FDI threatens to raise the cost of attracting it, a new countertrend may be emerging, to limit the availability of FDI for development in poorer countries, and to raise the risk of distorted investment flows.[9] For those trying to understand the content of the law of international investment, the problem is that these succeeding historical developments have not necessarily replaced or preempted preceding historical developments; rather, they are layered one on top of the other in an uneasy state of coexistence.[10]

Resolving–or perhaps even preventing–disputes over FDI has become primarily the role of three other historical developments. First, the emergence of the BIT has been quite significant;[11] over seven hundred BITs are currently in force. Second, national investment guarantee programs–like the U.S. Overseas Private Investment Corporation (OPIC) and the World Bank's Multilateral Investment Guarantee Agency (MIGA)– have ameliorated some risks associated with FDI. Third, institutions like the World Bank's International Centre for Settlement of Investment Disputes (ICSID)[12] provide what appear to be effective devices for the settlement of FDI disputes directly between investor and host country, without the necessity of falling back on older, traditional dispute settlement devices at the government-to-government level.[13]

NOTES AND QUESTIONS

1. The specific application and implications of these varied sources of law will be explored at various appropriate points throughout this book. In Chapter IX, we shall examine the effect of ICSID, as well as OPIC, BITs, and MIGA, on dispute settlement.[14]

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6. Sornarajah, *supra* note 4, at 281.

7. *I.e.*, transborder investment in capital projects.

8. For a useful discussion of privatization from the perspective of the International Bank for Reconstruction and Development, see Mary M. Shirley, *The What, Why, and How of Privatization: A World Bank Perspective*, 60 Fordham L. Rev. S23 (1992).

9. For example, in 1994 the UN Conference on Trade and Development (UNCTAD) called for international negotiations to curb incentives for foreign direct investment. UNCTAD, *Incentives and Foreign Direct Investment*, Doc. TD/B/ITNC/Misc. 1 (Apr. 12, 1995).

10. Thus, definitive treatment of the limits of competing national jurisdictions over transborder investment activity has yet to be achieved, but accommodation continues to be sought. For example, in 1984 the OECD adopted a statement on *Conflicting Requirements Imposed on Multinational Enterprises*, recognizing "relevant principles of international law" and calling for "cooperation as an alternative to unilateral action" by OECD member states. OECD, Comm. on Int'l Investment and Multinat'l Enterprises, *The 1984 Review of 1976 OECD Declaration and Decisions on International Investment and Multinational Enterprises*, OECD Doc. Press/A(84)28 (May 18, 1984).

11. *See, e.g.*, Gann, *The U.S. Bilateral Investment Treaties Program*, 21 Stanford J. Int'l L. 373 (1986) (discussing concerted efforts by United States to negotiate BITs).

12. Convention on the Settlement of Investment Disputes between States and Nationals of other States, 1965, 17 U.S.T. 1270, T.I.A.S. No. 6090, 575 U.N.T.S. 159.

13. A relatively new device for the settlement of investment disputes, at least at the regional level, is to be found in the North American Free Trade Agreement (NAFTA), concluded in 1992, which contains significant provisions on FDI. On NAFTA, see Chapter III, *infra*, at ▬. These provisions are mirrored in the provisions on Trade-Related Investment Measures (TRIMs) that appear in the WTO. On TRIMs, see Chapter XIV, *infra*, at ▬.

14. *See* Chapter IX, *infra* at ▬. ICSID will later be treated in more detail in Chapter XX, *infra* at ▬.

The relationship between FDI and international development theory will be explored in Chapter X.[15] Chapter XIV will consider GATS, TRIMs, and NAFTA[16] as examples of emerging legal regimes for trade in services. The regulation of FDI, both in terms of the FDI transaction itself and in terms of the broader issue of regulation of the multinational enterprises that engage in it, is examined in detail in Chapter XVII[17] and Chapter XIX[18] respectively. Finally, national regulation of transborder investment activities will be examined in Chapter XVIII.[19]

2. The problem of jurisdiction over transborder investment activities has grown more or less in the wake of the historical development of the corporate form of doing business. If corporation ***A***, organized under the laws of state ***X***, creates a wholly-owned subsidiary ***B***, organized under the laws of and operating in state ***Y***, which state has legitimate authority to regulate the investment? Which has authority to regulate the *conduct* of ***B*** once it starts operating? How about the conduct of ***A***? Traditional principles of public international law complicate matters, because these principles recognize a "territorial" basis for jurisdiction–allowing a state to regulate conduct that takes place in whole or in part within its territory–and a "nationality" basis for jurisdiction–allowing a state to regulate the conduct of its "nationals," wherever the conduct takes place. Does the following note from the Reporters of the Third Restatement of the Foreign Relations Law of the United States help in answering the questions posed above?

RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW
§ 414, Reporters' Note 1 (1986 Main Vol.)

> When aggregations of capital with limited liability grew to prominence in the nineteenth century, it was usually understood that a corporation was created by or under the laws of a single state (or subdivision of a state), that it could operate only in that state, and that its activities were subject only to the laws of that state. If a state permitted a foreign corporation to act in its territory without local incorporation, the corporation was subject to the law of the state. Transnational economic activity was carried out predominantly through trade or extension of credit; individual nationals invested in foreign corporations, but transnational investment by corporations was rare. Thus the territorial principle and the bases of corporate law were in harmony and gave rise to the traditional rule that the regulation of a corporation was the responsibility of the state of incorporation. By the first World War, a few major companies, predominantly in oil and mining, had developed integrated enterprises consisting, typically, of separate companies incorporated in different states, but operating under a single corporate name, with common ownership, management and personnel practices, shared technology and trademarks, and usually the same or closely related products. In the period since World War II, multinational enterprise has become the dominant form of participation in the world economy, and transnational direct investment has been at least equal in volume to trade in goods and services, embracing virtually all sectors of the economy. The basic rule [of territorial jurisdiction] has remained the point of departure for jurisdiction over corporate activity, but qualifications to this rule have grown up in state practice, derived from or analogous to the nationality principle. . . .

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15. *See* Chapter X, *infra* at ▬.
16. *Cf.* note 13, *supra* (discussing NAFTA and TRIMs).
17. *See* Chapter XVII, *infra* at ▬.
18. *See* Chapter XIX, *infra* at ▬.
19. *See* Chapter XVIII, *infra* at ▬.

> The United States, as home state of parent companies of multinational enterprises, has asserted the right to exercise jurisdiction over certain activities of companies organized under the laws of foreign states but owned or controlled by United States-based corporations. . . . Other states, such as Canada and some developing countries, as well as the [EU], have exercised limited jurisdiction over foreign subsidiaries of multinational enterprises based in their countries, and have also "pierced the corporate veil" to exercise jurisdiction over parent companies whose subsidiaries are organized under their laws. . . . Some relationships other than corporate affiliation, such as links of contract or license, have sometimes been relied on as the basis for jurisdiction to prescribe [rules], but those links do not come within the [territorial or nationality] principles . . . and require other justification to support the exercise of jurisdiction.

3. The European Court of Justice, the highest court of the EU, has repeatedly upheld assertions by the EU Commission in competition cases (*i.e.*, antitrust cases) of jurisdiction over non-EU parent corporations with EU subsidiaries. *Imperial Chemical Industries Ltd. v. Commission*, Case 48/69, [1972] E.C.R. 619, 662 (the Dyestuffs case); *Europemballage Corp. and Continental Can Co., Inc. v. Commission*, Case 6/72, [1973] E.C.R. 215, 242; *Istituto Chemioterapico Italiano SpA and Commercial Solvents Corp. v. Commission*, Case 6 and 7/73, [1974] E.C.R. 223, 253-55. In such cases, the conduct of the subsidiary is typically imputed to the parent on the basis of ownership and control by the parent over the subsidiary's activities despite the separate corporate status of the subsidiary.

4. The Charter of the International Monetary Fund (IMF) contains rules that restrict to some extent the authority of member states to regulate international investment. *See, e.g.*, Rest. (3d) of Foreign Relations Law, § 821 (discussing IMF rules). For example, member states are prohibited, absent IMF approval, from restricting payments or transfers involving "current international transactions," except where a member state has reserved the right to impose such restrictions as part of "transitional arrangements" under the Charter. Current transactions include such transfers as dividend payments and depreciation of direct investments, but not FDI transactions themselves. The latter are considered "capital transactions" and as such are not covered by the prohibition. As a basic multilateral rule in the law of international investment, does this distinction make sense? What are its implications for the risks of FDI for the investor?

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