THE AUTONOMY OF LETTERS OF CREDIT

Dulien Steel Product Inc. of Washington v. *Bankers Trust Co.*

Dulien Steel Product Inc. of Washington v. *Bankers Trust Co.*,[1] — in which a letter of credit was opened to secure a broker's commission[2] — tends to show how popular has the commercial letter of credit become after the Second World War.[3] The case also indicates that the law concerning this mercantile instrument has — at least in so far as its autonomy is concerned — become well settled.

The facts of *Dulien Steel Product Inc. of Washington* v. *Bankers Trust Co.*[1] were somewhat involved. The plaintiffs contracted to sell steel scrap to the European Iron and Steel Community. Messrs. Marco Polo Group Project Ltd. were entitled to commission from the plaintiffs for having arranged this transaction. For the payment of this commission to Marco Polo, plaintiffs procured a letter of credit from Seattle First National Bank. In accordance with the instructions of Marco Polo this letter of credit was opened in favour of one, Sica. The defendant-bankers confirmed this letter of credit. The letter of credit stipulated for payment against: (1) a receipt of Sica for the sum of the letter of credit, and (2) a notification of

7. Art. 132 (2A) of the Federation's Constitution. This clause was added by an amending Act of 1960 but is declaratory in effect.

8. A.I.R. 1948 P.C. 121.

1. 189 F. Supp. 922 (1960)

2. Normally, a letter of credit is issued for the finance of a commercial sale. A broker's commission can as conveniently be secured by a banker's guarantee or indemnity.

3. See also Gutteridge & Megrah, *The Law of Banker's Commercial Credits,* 3rd ed. (1960) at p. 4.

Seattle Bank to the defendants that the plaintiffs had negotiated documentary drafts under the contract of sale. Sica tendered the stipulated receipt and Seattle Bank informed the defendants that plaintiffs had negotiated documentary drafts. The defendants were not informed — at that time — that, after further negotiations between the plaintiffs and the vendees, the price of the contract-goods was reduced and that as a result the commission payable to Messrs. Marco Polo — for payment of which the letter of credit was issued — should have been reduced respectively. Only after the notification about the negotiation of documentary drafts by the plaintiffs, Seattle Bank brought these amendments in the underlying transaction to the attention of the defendants and asked them not to pay the full amount of the credit. Defendants were also informed that Sica was a mere nominee of Messrs. Marco Polo and had no rights of his own to the sum of the credit. Sica, however, claimed payment and the defendants, finally, paid him the full amount of the credit. Plaintiffs, thereupon, brought an action against the defendants for the recovery of the moneys paid to Sica.

Plaintiffs based their action on two grounds. In the first place they argued that, since the defendants were notified about the amendments in the contract of sale, they should have refused payment. It should have been clear to them that the changes in the contract-price affected the broker's commission and that the original sum of the letter of credit should have been reduced. The first contention was rejected by Van Pelt Bryan, Dis. J. who said: [4]

> When a bank confirms a letter of credit the letter evidences its irrevocable obligation to honor the drafts presented by the beneficiary upon compliance with the terms of the credit. The letter is quite independent of the primary agreement between the party for whose account it is issued and the beneficiary, or any underlying transactions. Neither the issuing nor the confirming bank has any obligation, and is not permitted, to go behind the terms of the letter and the documents which are required to be presented, and to enter controversies between the beneficiary and the party for whose account the letter was opened concerning any other agreements or transactions.

This disposed of the first argument of the plaintiffs. There is nothing revolutionary about this *dictum.* That letters of credit are independent of the underlying contract of sale is a well established principle. It holds true not in American[5] and English[6] law only, but also in French[7] and German[8] legal systems.

4. 189 F. Supp. at p. 927.

5. See: *Williams Ice Cream Co.* v. *Chase National Bank,* 120 Misc. Rep. 301, 199 N.Y.S. 314 (1923); *Imbrie* v. *D. Nagase & Co. Ltd.,* 187 N.Y.S. 692 at p. 695 *per* Rich J. (1921); *Frey & Sons Inc.* v. *E.R. Sherbrune Co.,* 193 App. Div. 849, 184 N.Y.S. 661 *per* Greenbaum J. at p. 663 (1920); *American Steel Corporation* v. *Irving National Bank,* 266 F. 41 at p. 44 *per* Rogers Cir. J. (1920); *Lamborn* v. *Lake Shore Banking & Trust Co.,* 196 App. Div. 604, 188 N.Y.S. 162 (1921); *Bank of Italy* v. *Merchants National Bank,* 113 Misc. 314, 185 N.Y.S. 43 (1920); aff'd 188 N.Y.S. 183 *per* Hubbs J. at p. 185 (1921); *Bank of Taiwan Ltd.* v. *Union National Bank of Philadelphia,* 1 F, 2nd 65 *per* Davis Cir. J. at p. 66 (1924); *Border National Bank of Eagle Pass, Texas* v. *American National Bank of San Francisco, Cal.*, 282 F. 73 at p. 80 (1922); *Moss* v. *Old Colony Trust Co.,* 246 Mass 139, 140 N.E. 803 at p. 808 (1923); *Laudisi* v. *American Exchange National Bank,* 239 N.Y. 234, 146 N.E. 347 at p. 350 (1924); *Brown* v. *Rosenttein,* 123 Misc. Rep. 787, 200 N.Y.S. 491 at p. 496 (1923); *Russel Grader Mfg. Co.* v. *Farmer's Exchange State Bank of Sunger,* 49 N.D. 494, 194 N.W. 387 (1923); *National City Bank* v. *Seattle National Bank,* 121 Wash. 476, 209 P. 705 at p. 707 (1922); *Banco Nacional De Credito Ejidal S.A.* v. *Bank of America,* 118 F. Supp. 308, *per* Roche J. at p. 310 (1954); *Kingdom of Sweden* v. *New York Trust Co.,* 197 Misc. 431, 96 N.Y.S. 2d 779 (1949).

6. *Urquhart Lindsay & Co.* v. *The Eastern Bank* [1922] 1 K.B. 318.

7. Stoufflet, *Le Credit Documentaire,* at pp. 312-313.

8. Wiele, *Das Dokumenten Akkreditiv*, at pp. 57-61.

The second contention of the plaintiffs was that Sica was a mere nominee or agent of Marco Polo. They pointed out that Marco Polo agreed to the amendments in the contract of sale and raised no objections to the amendments suggested for the letter of credit. The plaintiffs argued that, therefore, payment to Sica should have been refused. This contention, too, was rejected, in the following words: [9]

> Plaintiff's theory that the amendments became effective because Sica was in fact a mere collecting agent for Marco Polo, which had agreed to the amendments, is not supported by the facts. Whether or not Sica was a principal or collecting agent was no concern of bankers [defendants]. Sica was unqualifiedly named as the beneficiary in the letter of credit by Dulien [plaintiffs], at whose request and for whose account it was issued. Bankers [defendants] was obliged to pay the beneficiary and no one else.

Obviously, once the independence of the letter of credit is established, this conclusion becomes inevitable. If the issuing banker is not concerned with underlying relationships, he can hardly be asked to rely on statements or declarations of his customer which conflict, in any way, with the terms of the letter of credit.[10]

In order to overcome the difficulty of this independence of the letter of credit plaintiffs raised a third contention. They made an attempt to resort to a plea of fraud. They contended that Sica's demand of the sum of the credit amounted to fraud, and referred to the decision of Shientag J., delivered in the Appellate Division of the Supreme Court of New York, in the case of *Sztejn* v. *J. Henry Schroeder Banking Corporation.* [11] The facts of this case were as follows: The plaintiffs contracted to purchase bristles from an Indian firm. At the instructions of the plaintiffs, the defendants opened a letter of credit in favour of the sellers. The sellers obtained from the shipowners documents which, on their face, were regular. Yet, though the documents described the shipped goods as bristles, the crates, in fact, contained rubbish. The buyers, who knew about this fraud, brought an action for an injunction to restrain the bankers-defendants from making payment against these documents. Granting this injunction, Shientag J., said: [12]

> In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.

Van Pelt Bryan, Dis. J. refused to apply this doctrine of the *Sztejn's* case to *Dulien's* case. He said: [13]

> As far as Bankers [defendants] were concerned the only information which it had was Dulien's [plaintiffs] claim transmitted by Seattle Bank [the issuer who ordered defendants to confirm the credit] that its obligation 'under the letter of credit' was to Marco Polo and not to Sica and the amendments said to have been agreed to between Marco Polo and Dulien. The statement as to Dulien's obligation under the letter of credit flew directly in the face of terms and conditions of the letter [of credit] which had been issued at Dulien's own instance . . .

9. 189 F, Supp. at p. 927.

10. See also: *Laudisi* v. *American Exchange National Bank,* 239 N.Y. 234, 146 N.E. 347 (1924).

11. 177 Misc. 719, 31 N.Y.S. 2d. 631 (1941),

12. At p. 634.

13. F. Supp. at p. 929,

It is not within the scope of this case-note to discuss at length the validity of the fraud rule in the *Sztejn's* case. While textbook writers tend to support this doctrine,[14] it seems, nevertheless, that the decision of the Court of Appeal of the State of New York in *Maurice O'Meara* v. *National Park Bank of New York*[15] would cast some doubt on its correctness.[16] *Dulien's* case, though not declaring the rule of the *Sztejn's case* bad law, tends to limit its application. It denies the relevancy of a fraudulent statement which is not directly connected with the terms of the letter of credit. It should be noted that in *Dulien's* case the fraud, if proved, would have been one on the buyer and not on the banker, *i.e.* on the terms of the underlying transaction and not on the letter of credit. As far as the bankers were concerned, Sica was the beneficiary of the letter of credit. The contention that Sica was a mere nominee was contradicted by the terms of the credit. His position as collecting agent for Marco Polo was a matter provided in the contract between Marco Polo and Dulien, *i.e.* the underlying transaction which led to the opening of the letter of credit. Fraud on such a term in an underlying transaction, which flew in the face of the provisions of the letter of credit, was held to be irrelevant.

It is felt that also this part of the decision in *Dulien's* case is unexceptionable. It is true that it might well be dangerous to allow an unscrupulous seller to benefit from technicalities connected with a letter of credit. Yet, it would be not less dangerous to recognize doctrines which would destroy the independence and autonomy of this valuable instrument. It would be wrong to allow a banker to avoid his undertaking in a letter of credit because the seller defrauded the buyer. In so far as the fraud is not upon the banker and the terms of the letter of credit, it should be treated by the banker as irrelevant. Actually, how could the banker be in a position to judge what amounts to fraud? Moreover, what should be regarded as "knowledge of the fraud" on part of the banker? Certainly not declarations of his customer.[17] Otherwise, a seller would be placed in the hands of an unscrupulous buyer who might, without any good reason, claim that a fraud was committed. One should note that the main purpose of a letter of credit is not to protect the buyer but to give an unfailing security to the seller, who parts with the property over his goods. An importer can easily protect himself by including all relevant terms of the contract of sale in his application for a credit, and by stipulating for payment against certificates of origin of reputable surveyors or chambers of commerce. It is submitted that lack of diligence on part of the instructing customer-importer should not result in potential loss to the banker. It would be unsound to force the banker to decide, at his peril, whether to act on the statement of his customer, or to disregard it and accept regular documents tendered by the seller despite the customer's allegation of fraud.

14. See: Gutteridge & Megrah, *op. cit*., at pp. 111-112. Davis, *The Law Relating to Commercial Letters of Credit,* 2nd ed. (1954) at pp. 160-164.

15. 239 N.Y. 386, 146 N.E. 639 (1924); aff'd 240 N.Y. 607, 148 N.E. 729 (1925) .

16. In that case a banker refused to honour a draft, with regular documents attached to it, presented by the seller. The banker contended that the description of the quality of the goods in the bill of lading and invoice was false and fraudulent. If their true quality — which was a term of the credit — were stated the bankers would have been entitled to refuse the documents on the ground of non-compliance. Their misrepresentation was proved in the trial of an action brought by the seller against the bankers. The bankers were, nevertheless, held to have been at fault. McLaughlin J. said: "The bank was concerned only in the drafts and the documents accompanying them.... 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 what it knew or had reasons to believe...." (146 N.E. at p. 639).

17. *Laudisi* v. *American Exchange National Bank,* 239 N.Y. 234, 146 N.E. 347 (1924).

The only practical, sound, solution to the problem of fraud is the one following from *Dulien's* case. Any fraud which goes beyond the terms of the letter of credit should be ignored by the banker. It is felt that *Dulien Steel Product Inc. of Washington* v. *Bankers Trust Co.*[18] is, thus, a most commendable authority. It underlines the doctrine that letters of credit are independent of any other contractual relationship. And it is to be hoped that the limitations imposed by it on the rule in the *Sztejn's* case will be observed in subsequent cases.

E. P. ELLINGER.

18. 189 F. Supp. 922 (1960).