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Letter of Credit Dishonor Risk Where Copies Presented in Lieu of Originals

SAVVY CREDITORS ARE WELL AWARE OF THE BENEFITS OF A LETTER OF CREDIT (LC). AN LC PROVIDES A SAFETY NET FOR UNSECURED CREDITORS BY SERVING AS A BACKSTOP IN THE EVENT A CUSTOMER DEFAULTS ON ITS CONTRACT WITH THE CREDITOR OR OTHERWISE FAILS TO PAY OUTSTANDING INVOICES OWING TO THE CREDITOR.

One of the central principles of LC law is the doctrine of strict compliance. A creditor seeking to draw on an LC must strictly comply with all of the LC's documentary requirements. So, what exactly is considered "strict compliance?" As illustrated by two relatively recent state appellate court opinions—one out of Pennsylvania, in *Windsor Twp. v. Tompkins Financial Corp.* (September 2022) and another out of Massachusetts in *ProQuip Ltd. v. Northmark Bank* (August 2023)—courts tend to construe the strict compliance requirement quite ... well, strictly.

OVERVIEW OF LETTERS OF CREDIT

An LC arrangement typically involves three parties and three contracts:

1. A contract between a creditor and debtor, with the creditor seeking an LC to backstop the debtor's performance of that contract.
2. A contract between the bank and the debtor, known as the LC applicant, who is arranging the issuance of an LC. This contract includes the terms governing the LC, the applicant's obligation to reimburse the bank for the bank's payments to the beneficiary upon the presentation of conforming documents, the collateral securing payment of the applicant's reimbursement obligation to the bank and all

fees and other charges owed to the bank in connection with the LC.

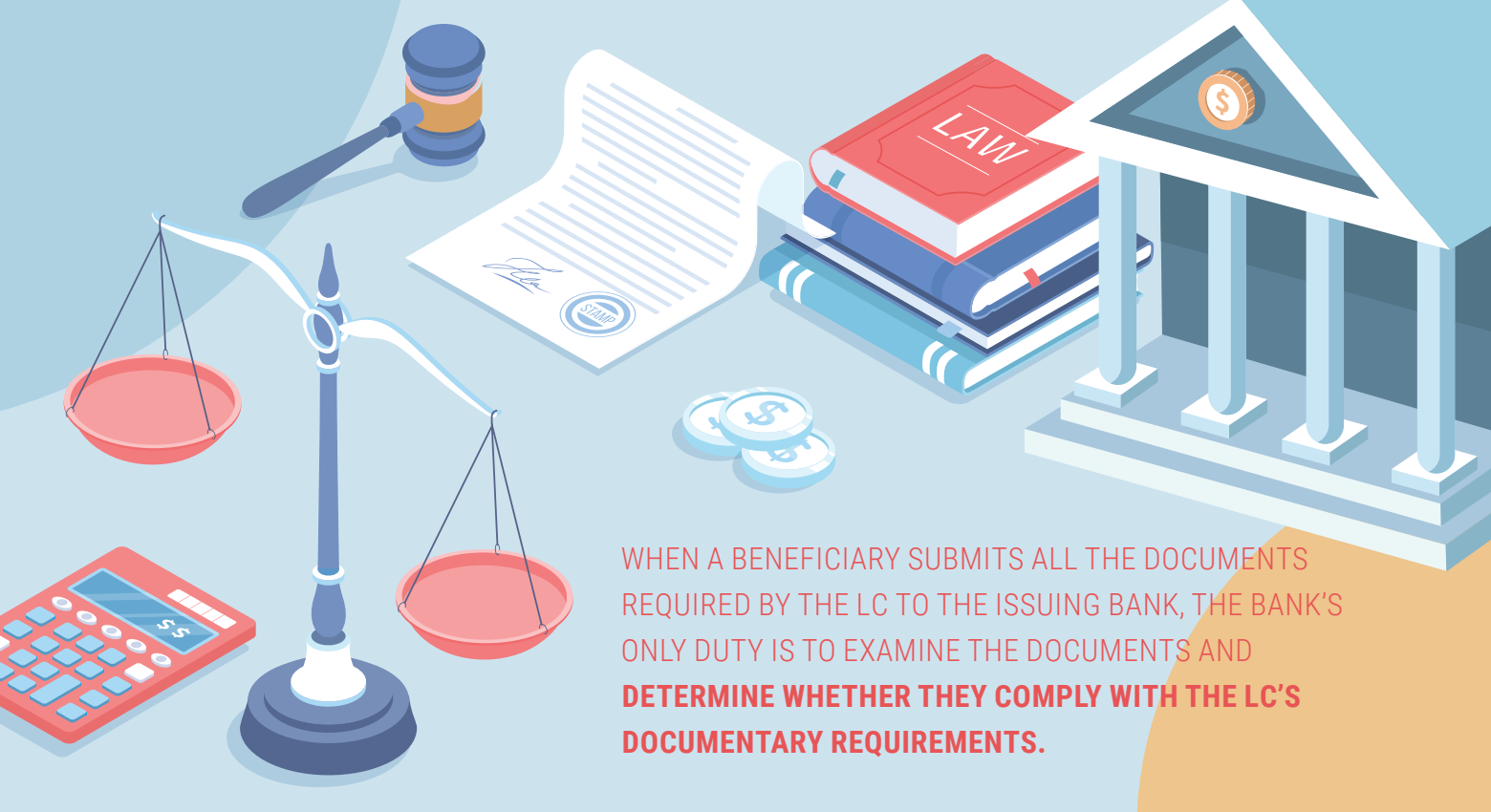
3. The LC itself is the third contract where the bank is issuing an LC in favor of the creditor, known as the LC beneficiary. When a beneficiary submits all the documents required by the LC to the issuing bank, the bank's only duty is to examine the documents and determine whether they comply with the LC's documentary requirements. If the beneficiary has satisfied all of the LC's documentary requirements, the bank must pay the amount requested by the beneficiary. If the bank rejects a beneficiary's presentation of conforming documents, the bank is in breach of its obligation to pay on the LC and is subject to the beneficiary's assertion of a wrongful dishonor claim.

The key to LC law is the independence principle. Each of the three contracts in an LC transaction is independent of one another. An issuing bank must honor the beneficiary's request for payment where the beneficiary presents all of the documents required by the LC. It does not matter that disputes exist between the beneficiary and the applicant in their transaction or whether the applicant is unable to reimburse the issuing bank for all payments received by the

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WHEN A BENEFICIARY SUBMITS ALL THE DOCUMENTS REQUIRED BY THE LC TO THE ISSUING BANK, THE BANK'S ONLY DUTY IS TO EXAMINE THE DOCUMENTS AND **DETERMINE WHETHER THEY COMPLY WITH THE LC'S DOCUMENTARY REQUIREMENTS.**

beneficiary. And if the issuing bank makes payment to the beneficiary based upon the beneficiary's presentation of noncomplying documents, the bank's customer/applicant is not obligated to reimburse the bank for that payment.

There are two types of letters of credit. The first is a "documentary" LC, where the beneficiary looks solely to the bank for payment. This type of LC is frequently used in international trade. The documents that a beneficiary must present usually include invoices, shipping documents, packing lists, insurance-related documents and other documents evidencing the beneficiary's sale and delivery of goods or services to the purchaser/applicant.

The second type of LC is a "standby" LC, where the beneficiary must first look to its customer for payment. A standby LC serves as a backstop for the applicant's performance of its obligations to the beneficiary. The beneficiary can draw on and obtain payment of a standby letter of credit by presenting a document or documents confirming the applicant's default. As such, a standby LC should contain simpler documentary requirements than those contained in a documentary LC. These requirements can be as simple as the beneficiary presenting a statement to the issuing bank that the applicant has defaulted in its transaction with the beneficiary.

Article 5 of the Uniform Commercial Code (UCC) is one of the sources of governing law for LCs. LCs might also be governed by the Uniform Customs and Practice for Documentary Credits (the most recent version is UCP 600), or by the International Standby Practices (ISP 98).

BACKGROUND REGARDING THE WINDSOR TWP. DECISION

Greth Development Group filed a subdivision plan with Windsor Township through which Greth sought permission to build 48 townhouses on a roughly 8.5-acre plot of land in the Township. The Township approved the plan and entered into an agreement that required Greth to take a number of steps to move forward with the development. The agreement included two requirements that ended up being particularly relevant to the *Windsor Twp.* decision. First, Greth was required to complete all mandated improvements for the development within one year. Second, Greth was required to obtain an LC that covered the full estimated cost for the development's improvement, which the Township would be authorized to draw upon if Greth defaulted under the agreement.

To satisfy the second requirement, Greth obtained a standby LC from the issuing bank. Among the LC's various conditions was that **"The original [LC] and all amendments, if any, shall be presented at the time of any drawings."** The LC was governed by both UCC Article 5 as enacted in Pennsylvania and by the earlier version of the UCP, UCP 500.

Greth failed to complete all improvements within one year. The Township sued Greth and also drew on the LC to obtain the funds necessary to finish the improvements. The issuing bank dishonored the Township's draw, and the Township filed a lawsuit asserting the bank had wrongfully dishonored the draw.

In the lawsuit, the parties filed competing motions for judgment on the pleadings. The issuing bank argued that it had the right to dishonor the Township's LC



EVEN A SMALL DEVIATION, SUCH AS PRESENTING A COPY OF A DOCUMENT WHERE THE LC REQUIRES AN ORIGINAL DOCUMENT, RISKS THE ISSUING BANK'S REFUSAL TO HONOR AN LC DRAW.

because the Township had failed to present the original LC to the issuing bank as the LC required. By its own admission, the Township had misplaced the original LC. Still, the Township argued it was entitled to payment of the LC by submitting a copy of the LC to the issuing bank (as it had done). The trial court ruled in the Township's favor, and the issuing bank filed an appeal to the Commonwealth Court of Pennsylvania.

BACKGROUND REGARDING THE PROQUIP DECISION

ProQuip Limited had entered into an agreement with Marblehead Winter Garments, LLC (MWG) through which MWG had agreed to purchase golf apparel from ProQuip. The agreement required MWG to obtain an LC guaranteeing payment to ProQuip. MWG procured a standby LC that designated ProQuip as the beneficiary. The LC included the following documentary requirements: "Credit shall be available with us by payment against presentation of ... **the original of and all amendments, if any, to this Letter of Credit for our endorsement.**" The LC was governed by Article 5 of the UCC as enacted by Massachusetts and the UCP.

The LC was scheduled to expire within one year of its issuance. Two days before the expiration date, at MWG's request, the issuing bank issued an amendment to the LC, which extended the LC by one year. The LC amendment also provided for automatic renewals of the LC subject to the issuing bank's right to terminate the LC on 45 days' written notice to ProQuip.

The LC automatically renewed for many years until, in 2020, the issuing bank notified ProQuip that the bank would not renew the

LC. Before the LC expired, ProQuip made a demand for payment under the LC that included presenting the original LC and an "Original Document Affidavit and Indemnity" in which ProQuip's company secretary (1) stated that a diligent search had failed to locate the original amendment, and (2) ProQuip undertook to hold the bank harmless from an enumerated list of potential liabilities relevant to the LC amendment.

The issuing bank refused to honor the demand since ProQuip had failed to present the original amendment. ProQuip sued the issuing bank, asserting a wrongful dishonor claim and seeking payment of the LC. On competing cross motions for summary judgment, the lower court ruled in ProQuip's favor. The court held the LC did not require the beneficiary's presentment of the original of the amendment, there was "no risk that [the issuing bank] will be harmed", and equity supported judgment in ProQuip's favor. The issuing bank appealed the decision to the Commonwealth of Massachusetts Appeals Court.

THE COURTS' DECISIONS

Both appellate courts reversed and upheld the issuing banks' dishonor of the LCs. The courts noted that the LC beneficiaries had failed to strictly comply with the LCs' documentary requirements by failing to submit originals of the required documents as unambiguously required by the LCs.

The *Windsor Twp.* court relied on UCC section 5-108(a), which adopts the strict compliance standard. The court also relied on Article 20(b) of UCP 500, which states that "[u]nless otherwise stipulated in the [letter of credit], banks will also accept as an original document(s), a document(s) produced or

appearing to have been produced: (i) by reprographic, automated or computerized systems; [or] (ii) as carbon copies; provided that it is marked as original and, where necessary, appears to be signed." The court noted that rules of contract interpretation may be utilized to examine whether the terms of an LC are ambiguous or to resolve such an ambiguity—but there was no ambiguity in its case. The LCs clearly required the Township to submit the original LC to the Issuing Bank.

The *ProQuip* court went a bit further in analyzing the UCC. In addition to citing the strict compliance standard under UCC section 5-108(a), the court relied on section 5-108(e), which states that "[a]n issuer shall observe standard practice of financial institutions that regularly issue letters of credit ...". The court then reasoned that "standard practice," based on the UCP and other court decisions interpreting LCs, requires presentment of the original of each document as required by the LC.¹ Interestingly, both courts leaned on the 1979 decision by the United States Court of Appeals for the *Third Circuit in Insurance Co. of North America v. Heritage Bank, N.A.*, that followed the strict compliance standard, stating:

"[E]ssential to the viability of [a letter of credit] is the certainty that it provides. Just as the beneficiary is induced to enter the underlying transaction because it is assured payment under specific terms agreeable to it, so too the bank assumes a primary obligation in part because its commitment is clearly defined within the four corners of the letter. If courts deviate from the rule of strict compliance and insist in certain undefined situations that banks make payments notwithstanding the fact that the beneficiary failed to comply with the terms stipulated in the letter of credit, the certainty that makes this device so attractive and useful may well be undermined, with the result that banks may become reluctant to assume the additional risks of litigation."

CONCLUSION

These two decisions illustrate the risk caused by an LC beneficiary's failure to strictly comply with an LC's documentary requirements. Even a small deviation, such as presenting a copy of a document where the LC requires an original document, risks the issuing bank's refusal to honor an LC draw. And, absent an ambiguity as to whether the LC requires

the production of original documents, the issuing bank's dishonor will almost certainly hold up in court! LC beneficiaries must ensure that they are able to strictly comply with the LC's documentary requirements, whether that means maintaining originals of relevant documents or negotiating for an LC that permits the presentation of copies.

Best practice for trade creditors seeking LC protection is to seek the removal of the requirement of presenting the original LC and all amendments as a part of any LC draw. Otherwise, the LC beneficiary risks being left without the security the LC was supposed to provide in the first place. **BC**

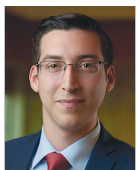
1. *The ProQuip court noted that the cases on which ProQuip had relied in arguing that an LC may be honored where an original document is missing were inapplicable because they involved draws based on later amendments for which the original was presented. That is, in these and other cases, the missing document was superseded by the original amendment that was presented, while in ProQuip, the operative amendment was missing.*



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With approximately 45 years of experience in the bankruptcy and insolvency field, Bruce is a recognized nationwide leader in trade creditor rights and the representation of trade creditors. Bruce has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed.



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Credit Managers Shed Light on **SUBCHAPTER V** Issues During Meeting with American Bankruptcy Institute

Several business-to-business (B2B) credit managers and bankruptcy attorneys from Lowenstein Sandler convened with the American Bankruptcy Institute (ABI) Subchapter V Task Force on Oct. 26, 2023 to exchange invaluable insights gleaned from their cumulative experiences in Subchapter V cases.

These credit managers, who are members of the esteemed National Association of Credit Management (NACM), played a pivotal role in orchestrating this collaborative dialogue, shedding light on critical matters within the Subchapter V landscape.

"The credit managers who participated in this opportunity gave the entire B2B credit industry a voice when it comes to Subchapter V," said NACM President Robin Schauseil. "We are thrilled that the Subchapter V Task Force took the time to listen to our members' concerns."

The debt ceiling for Subchapter V increased from \$2.5M to \$7.5M in total noncontingent, liquidated, secured and unsecured debt as part of the Coronavirus Aid, Relief, and Economic Security Act, or the CARES Act. NACM members testified that with this increased amount, which will sunset without Congressional action on June 21, 2024, Subchapter V bankruptcies have expanded to include medium-sized businesses rather than only small businesses.

"We hope the information we provide today will offer a different perspective on Subchapter V and our recommendations for the commission are considered as they move forward," said Mike Mandell, corporate collection manager at Ryder System, Inc. (Miami, FL). "I have yet to see a Subchapter V plan succeed. The Subchapter V plans that Ryder has been involved in have failed where the customer stops paying."

Credit professionals testified that debtors should not be able to use Subchapter V to prolong the life of a company that cannot successfully reorganize. A primary concern of trade creditors is the inherent imbalance created by Subchapter V of the Bankruptcy Code. Subchapter V allows small businesses to avail themselves of substantially all of the benefits of a traditional Chapter 11 case through an expedited process at a minimal cost to the debtor. However, the creditors who bear the burden of those benefits are left without the most significant protections of Chapter 11 and, to protect their interests, would have to incur the same costs.

"The lack of disclosures and the reduction of available information for creditors in this subchapter is a major pain point," said Conrad Ragan, director of corporate credit risk at PepsiCo (Winston Salem, NC).

Trade creditors are the lifeblood of our economy, currently providing approximately \$5.6 trillion of capital to businesses in the United States, most of which is extended on an unsecured basis.

"We do business with companies across all industries and sizes, so we have seen quite a few different types of bankruptcies, including many Subchapter V cases over the last few years," said Jeff Weber, director of credit at Uline (Pleasant Prairie, WI). "These claims can be made over three to five years, so it creates a burden for us to collect and ensure payments are being made."

The ABI Subchapter V Task Force is committed to reviewing the implementation and administration of Subchapter V of Chapter 11 of the Bankruptcy Code. The Task Force will study and evaluate case law and statistical data under Subchapter V. The Task Force intends to memorialize the results of its study in a written report.