INTRODUCTION
A standby letter of credit is a security device where the bank or other entity issuing the letter of credit agrees to pay a letter of credit beneficiary that presents all of the documents conforming to the requirements of the letter of credit. A standby letter of credit usually requires the presentation of documents that evidence a default in the underlying transaction between the letter of credit beneficiary and typically a third party that arranges for the issuance of the letter of credit—the letter of credit applicant.

One of the central tenets of letter of credit law is the doctrine of strict compliance. It requires the letter of credit beneficiary to comply precisely with all of the requirements of the letter of credit. That means presenting all of the documents required by, and making sure the presented documents strictly comply with, the documentary requirements of the letter of credit. Documents that are nearly the same simply will not cut it!

The rigorous nature of the strict compliance standard is demonstrated in a recent court decision, National Union Fire Insurance Company of Pittsburgh PA v. Standard Federal Bank N.A., a case pending in the United States District Court for the Eastern District of Michigan. The letter of credit beneficiary had presented the issuing bank with a sight draft in excess of the amount available for payment under the letter of credit. The issuing bank dishonored the draft because it did not strictly comply with the requirements of the letter of credit. The beneficiary sued the issuing bank, claiming wrongful dishonor of the beneficiary's drawing under the letter of credit. The court rejected the beneficiary’s claim and held that the bank had properly dishonored the drawing because the beneficiary’s overstated draft did not strictly comply with the letter of credit.

The moral of the story: the requirement of strict compliance means what it says! According to the National Union court, that means a letter of credit beneficiary faces the risk of dishonor when it presents a draft/demand for payment in excess of the amount available for payment under the letter of credit.

OVERVIEW OF STANDBY LETTERS OF CREDIT
A standby letter of credit is used in many transactions as a backstop that protects the letter of credit beneficiary from a default in its transaction with a third party, usually the letter of credit applicant. A letter of credit arrangement involves three parties and three independent contracts. The first contract is the underlying contract between the letter of credit applicant and beneficiary. That could be a contract for the sale of goods or provision of services, a lease, license, note, or other agreement. The second contract is the bank’s agreement, usually with the letter of credit applicant. This contract includes the bank’s agreement to issue the letter of credit, the terms of the letter of credit, the applicant’s obligation to reimburse the bank for payments made to the beneficiary upon the presentation of conforming documents as well as the bank’s charges and commissions earned from issuing the letter of credit, and the collateral security for the applicant’s reimbursement obligation to the bank. The third contract is the standby letter of credit that the bank issues in favor of the beneficiary upon the presentation of conforming documents as well as the bank’s charges and commissions earned from issuing the letter of credit.

One of the central tenets of letter of credit law is the principle of independence. Each of the contracts in a letter of credit transaction is independent of the other. For example, if the beneficiary presents the required documents, the issuing bank must pay the letter of credit, regardless of disputes between the beneficiary and the applicant in their underlying transaction and/or applicant’s financial inability to reimburse the bank for letter of credit.
payments and charges. And if the issuing bank makes payment to the beneficiary based upon the beneficiary’s presentation of non-complying documents, the applicant’s obligation to reimburse the bank for that payment is extinguished.

The primary concern of the bank issuing the letter of credit is to determine whether the beneficiary presented documents that comply with the terms of the letter of credit. The bank deals only in documents presented by the beneficiary when deciding whether to pay on a letter of credit. If the documents comply, the bank must pay the beneficiary; if the documents do not comply, the bank cannot make payment under the letter of credit, unless the applicant agrees otherwise. But how does the bank determine compliance? Most courts follow the strict compliance standard—that the presented documents must strictly comply with the letter of credit’s documentary requirements before payment can be made. As the National Union court made clear, that means a draft exceeding the amount of the letter of credit does not strictly comply with the requirements of the letter of credit, and is grounds for the issuing bank’s refusal to make payment to the beneficiary.

**THE FACTS OF THE NATIONAL UNION CASE**
The predecessor of Standard Federal Bank N.A. had issued a standby letter of credit (the “LC”) in favor of National Union Fire Insurance Company and The Insurance Company of the State of Pennsylvania (collectively the “LC Beneficiaries”) on behalf of the LC applicant, Affinity Business Systems (“Affinity”). The LC required the issuing bank to pay certain sums on certain dates to the LC Beneficiaries if the documentary conditions of the LC were satisfied. The LC amount started at $500,000 and was supposed to increase in two $500,000 increments up to $1,500,000 upon Affinity’s payment of each of the $500,000 increments to the bank. The LC further provided that if the issuing bank did not receive each of the $500,000 payments by certain deadlines, the amount of the LC would be limited to not more than $500,000.

Affinity never paid the additional installments and the letter of credit expired at the close of business on June 15, 2002.

The LC Beneficiaries waited until the last minute, June 14, 2002, the day before the LC’s expiration, to make their drawing on the LC. That turned out to be mistake number one! The LC Beneficiaries presented a sight draft demanding payment of $1,500,000, which exceeded the maximum amount payable under the LC, $500,000. The issuing bank had properly dishonored a draft that exceeded the amount of, and, therefore, did not strictly comply with, the LC.

The court disagreed, finding instead that the LC’s plain language suggested that the LC Beneficiaries could have requested payment of less than the total amount available under the LC. That clause did not impose an obligation on the issuing bank to pay the amount available under the LC in response to the LC Beneficiaries’ submission of a draft that exceeded such amount.

**CONCLUSION**
In the National Union case, the strict compliance standard cut against the LC Beneficiaries. The LC Beneficiaries presented a draft for $1,500,000, which exceeded the maximum amount payable under the LC, $500,000. The issuing bank had properly dishonored a draft that exceeded the amount of, and, therefore, did not strictly comply with, the LC.

The LC Beneficiaries might have had a better chance of payment of the LC if they had presented a sight draft for $500,000, the maximum amount available for payment under the letter of credit, rather than the $1,500,000 sight draft they had presented for payment. The LC Beneficiaries also should not have waited until just one day before the LC’s expiration date to make their request for payment. The LC Beneficiaries should have waited until just one day before the LC’s expiration date to make their request for payment of the LC. An earlier draw followed by a dishonor might have given the LC Beneficiaries sufficient time to present a corrected sight draft in the amount of $500,000.

Valuable lessons that should be taken to heart by all LC beneficiaries!

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