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Letter of Credit Coverage of Preference Risk : Overcoming a Fraud Injunction

A standby letter of credit is a valuable risk mitigation tool. A letter of credit issuing bank must honor a beneficiary's request for payment of a letter of credit where the beneficiary presents *all* of the documents required by the letter of credit. So you would think that the bank must pay the beneficiary when the beneficiary presents a statement that the liability of its customer remained unpaid at maturity, as required by the letter of credit. But what happens when the beneficiary submits the required statement to the bank and includes both its unpaid claim and its potential preference liability as part of the amount of its draw on the letter of credit?

The New York State Appellate Division, First Department (the "Appellate Court"), a well-respected mid-level court in *Foreign Venture Limited Partnership v. Chemical Bank* ("Foreign Venture"), dealt with this precise scenario—where the beneficiary drew on two letters of credit for its unpaid claim and most of the amount

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demanding on a preference claim arising under Australia's bankruptcy law against the beneficiary. The beneficiary claimed that its compliance with the documentary requirements of the letters of credit—its submission of a statement that the liability of the beneficiary's customer remained unpaid at maturity—entitled it to payment. The letter of credit applicant sought injunctive relief barring payment of the beneficiary's potential preference liability, invoking the fraud exception to the issuing bank's obligation to pay the letters of credit.

The Appellate Court vacated the injunction granted by the lower court barring the bank's payment of the letters of credit. The beneficiary's statement presented to the bank complied with the terms of the letters of credit and the beneficiary's inclusion of its preference risk as part of its letter of credit draws did not rise to the level of fraud that justified injunctive relief barring the bank's payment.

Overview of Standby Letters of Credit

Trade creditors frequently rely on a standby letter of credit as a backstop to payment of their claims. A standby letter of credit beneficiary first looks to its

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customer for payment and draws on the letter of credit if its customer fails to timely pay its obligations owed to the beneficiary.

A letter of credit arrangement typically involves three parties and three independent contracts. The first contract is the underlying contract, such as a contract for the sale of goods, between the letter of credit applicant and the beneficiary. In the *Foreign Venture* case, the letter of credit applicant had arranged for Commercial Banking Company of Sydney, Ltd. ("Commercial"), located in Sydney, Australia, to provide financing for the applicant's Australian affiliate.

The second contract is the issuing bank's agreement with its customer, 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 customer's obligation to reimburse the bank for payments made to the beneficiary upon the presentation of conforming documents, the bank's charges and commissions earned from issuing the letter of credit, and the collateral security for the customer's reimbursement and other obligations to the bank. In *Foreign Venture*, the letter of credit applicant arranged for Chemical Bank ("Chemical") to issue two irrevocable standby

letters of credit totaling US \$480,000 in favor of Commercial and caused one of the applicant's affiliates to pledge cash to Chemical to secure the applicant's obligation to reimburse Commercial for any payment made on the letters of credit.

The third contract is the standby letter of credit that the bank issues in the beneficiary's favor. When the beneficiary submits documents to the issuing bank, the bank's only duty is to examine the documents to determine whether they comply with the terms of the letter of credit. If the bank determines that the beneficiary has presented all of the documents required by the letter of credit, the bank *must* pay the amount requested by the beneficiary. If the bank rejects a beneficiary's presentation of conforming documents, the bank is subject to the beneficiary's assertion of a wrongful dishonor claim.

The independence principle is one of the central tenets of letter of credit law. Each of the contracts in a letter of credit transaction is independent of the other contracts. The issuing bank's obligation to pay on a conforming draw is independent of the beneficiary's performance of the underlying contract that the letter of credit was intended to backstop. The bank must honor the beneficiary's request for payment upon the presentation of confirming documents. Any disputes

concerning the beneficiary's performance of its obligations under, by way of example, its sale contract with its buyer, and/or the applicant's inability to reimburse the bank for any letter of credit drawings, have no bearing on the bank's obligation to make payment to a beneficiary that presents documents complying with the terms of the letter of credit.

The independence principle is one of the central tenets of letter of credit law. Each of the contracts in a letter of credit transaction is independent of the other contracts.

Another central tenet of letter of credit law is that an issuing bank deals only in documents presented by the beneficiary when deciding whether to pay on a letter of credit. If the documents comply with the requirements of the letter of credit, the bank must pay the beneficiary. On the other hand, if the documents do not comply, the bank cannot make payment to the beneficiary, unless the applicant agrees otherwise. Most courts follow the strict compliance standard in determining

NACM DESIGNEE SPOTLIGHT



Shelley Hart, CBF

Two decades ago, Shelley Hart, CBF, started her career as a credit professional and for the last 15 years, has worked for Wichita Sheet Metal Supply Inc. As a longtime supporter of NACM, Shelley attended several conferences and trade group meetings. She also took advantage of NACM's educational offerings, earning her CBA in 2004 and CBF in 2007. Below Shelley shares her educational journey.

What was your experience with NACM's designation process?

With the support of WSM, I have been able to expand my education by attending credit conferences, seminars and Credit Congress. I was so impressed with the knowledge and confidence of fellow credit professionals who held various designations that I decided credit certification was something I wanted to pursue.

I was able to use my accounting courses from the local community college and in 2004, earned the CBA designation. Down the road, I enrolled in Business Law and Credit Law online to start working toward the CBF designation which I earned in 2007. After completing the first two designations, I decided to finish my college degree and in 2010 graduated with an AAS degree in Business Management.

How have the designations helped in your career and would you recommend them to other credit professionals?

For me, attaining credit certifications is a statement that I take my credit career seriously. I want to be more than just the credit manager; I want to be seen as a credit professional. I feel that upper management and the sales department has more respect for me and the decisions I make due to my dedication to the profession. I think customers have more respect for me as well. They see the designation behind my name, and although they may not know what it means, they know it is something I had to earn.

What is one of the most important things you've learned?

I would say that there is no substitute for education, whether formal or informal. Take advantage of formal education through NACM seminars and classes, and informal learning through NACM industry trade groups and credit colleagues. The more we learn, the more we grow and the better we become.

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compliance, meaning that the presented documents must *strictly* comply with the letter of credit's requirements before the issuing bank can pay the beneficiary.

There is a very narrow fraud exception to the issuing bank's obligation to pay against conforming documents presented by a beneficiary. The letter of credit issuing bank can dishonor a beneficiary's draft or demand for payment if the documents

Most courts follow the strict compliance standard in determining compliance, meaning that the presented documents must *strictly* comply with the letter of credit's requirements before the issuing bank can pay the beneficiary.

presented to the bank are fraudulent or forged or if there is "fraud in the transaction." A letter of credit applicant, like the applicant in the *Foreign Venture* case, can also seek an injunction to bar any draws on and/or payment of a letter of credit based on the beneficiary's fraud. The *Foreign Venture* decision highlights just how difficult it is to prove fraud in attempting to bar payment of a letter of credit in the face of compliant draws. The Appellate Court held that the beneficiary's inclusion of its preference risk as part of its draws on the letters of credit did not rise to the level of fraud to justify injunctive relief barring payment.

Facts

Foreign Venture Limited Partnership ("FVLP") sought to arrange financing from Commercial for its Australian affiliate Venture Carpets PTY., Ltd. ("PTY"). FVLP caused Chemical to issue two irrevocable letters of credit totaling U.S. \$480,000 in favor of Commercial. Chemical agreed to make payment to Commercial "against [Commercial's] request stating that the liability or any part thereof by Venture Carpets PTY., Ltd. to [Commercial] remains unpaid at maturity and that [Commercial's] drawing on this credit covers the portion which remains unpaid." The letters of credit did not provide that Commercial could draw on the letters of credit to cover any potential preference liability.¹

Commercial provided financing to PTY following the issuance of the letters of credit and, thereafter, PTY began experiencing financial difficulty. As a result, PTY's inventory and equipment located in Australia were sold and proceeds totaling \$A (Australian) 355,947 were deposited in PTY's account with Commercial. Commercial then reduced PTY's indebtedness to Commercial to \$A 135,717. That same day, a bankruptcy petition was filed in Australia against PTY and an official liquidator (the "Liquidator") was appointed.

On December 29, 1976, the Liquidator demanded Commercial's payment of \$A 355,947 based on a preference claim against Commercial asserted under Australia's bankruptcy

law. Thereafter, Commercial debited the amount of the preference demand, \$A 355,947, against PTY's account, thereby increasing the amount of the claim on Commercial's books against PTY, which now exceeded the U.S.\$480,000 available under the letters of credit. Commercial then drew the full amount of the letters of credit on December 31, 1976, the date the letters of credit expired, after submitting the required statement that the liability of PTY to Commercial remained unpaid at maturity. Commercial had not paid off its alleged preference liability to the Liquidator when Commercial made its letter of credit drawings.

After Commercial drew on the letters of credit, FVLP filed a complaint against Chemical and Commercial in the New York Supreme Court, New York County (the "Trial Court"). FVLP sought an injunction enjoining Chemical from paying and Commercial from demanding or accepting payment of funds under the letters of credit based on a draw that was fraudulent because it included Commercial's potential preference liability. On February 11, 1977, the Trial Court granted a preliminary injunction barring payments of the letters of credit attributable to Commercial's potential preference liability, and denied Chemical's and Commercial's motions to dismiss the complaint.²

In March of 1977, the Supreme Court of Victoria in Australia determined that Commercial had preference liability of \$A 238,272, out of an original preference demand of \$A 355,947. On March 11, 1977, Commercial paid \$A 238,272 to the Liquidator. Thereafter, Chemical and Commercial moved for a rehearing and reargument of the Trial Court's ruling. The Trial Court denied that request and Chemical and Commercial then appealed to the Appellate Court.

The Appellate Court held that the beneficiary's inclusion of its preference risk as part of its draws on the letters of credit did not rise to the level of fraud to justify injunctive relief barring payment.

The Foreign Venture Limited Partnership v. Chemical Bank Decision

The Appellate Court vacated the preliminary injunction barring Chemical's payment of the letters of credit. The court held that Commercial was entitled to full payment of the letters of credit because Commercial had submitted the required statement and thereby complied with the documentary requirements of the letters of credit. The beneficiary's draws on the letters of credit that included its potential preference liability as part of its unpaid claim did not rise to the level of fraud that justified nonpayment of the letters of credit. Commercial had presented documents complying with the letters of credit and acted in good faith in including its preference risk as part of its claim when it drew on the letters of credit.

Any dispute over its draws did not warrant enjoining payment of the letters of credit.

Conclusion

A standby letter of credit is a potent risk mitigation tool that a trade creditor can use to increase the likelihood of payment of

Best practices suggest that a trade creditor concerned about preference risk should make sure that the standby letter of credit it obtains expressly permits a drawing for preference liability on top of unpaid amounts due.

its claim. In *Foreign Venture*, a beneficiary that presented conforming documents successfully vacated an injunction barring payment of the letters of credit. It did not matter that the beneficiary sought payment of previously paid indebtedness subject to preference risk.

Notwithstanding the court's decision, best practices suggest that a trade creditor concerned about preference risk should

make sure that the standby letter of credit it obtains expressly permits a drawing for preference liability on top of unpaid amounts due. ■

1. While the preference claim discussed in this article arose under Australia's bankruptcy law, the same principles should apply to a U.S. beneficiary's letter of credit draw, which includes its U.S. preference risk.

2. As FVLP conceded that \$A 136,456 was owed to Commercial, that amount was excluded from the injunction and was paid by Chemical to Commercial.

Bruce Nathan, Esq. is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM and is a former member of the Board of Directors of the American Bankruptcy Institute and is a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at bnathan@lowenstein.com.

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