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Tim A. Forgeron

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III. CONCLUSION

In *Barker v. Allied Supermarket* the Oklahoma Supreme Court held that a contract for sale giving rise to an implied warranty of merchantability is created when, before payment, a consumer in a self-service store takes physical possession of goods by removing them from the store shelf. The court reasoned that the merchandise on the store shelf represents an offer to the consumer to enter into a contract; the consumer can accept that offer by promising to pay for the goods as evidenced by the act of taking physical possession of them by removing them from the shelf. Moreover, the buyer's option to return unwanted merchandise does not affect this contract formation. In so holding, however, the court ignored the doctrine of mutuality of obligation. The court should have recognized that the consumer's right to return a product prior to paying for it renders unenforceable any implied agreement to purchase between the shopper and the retailer. While the UCC does provide a more flexible approach to contracting than traditional approaches, the court in essence found a contract when none existed.

Theodore W. Daniel

Standby Letters of Credit—True Letters of Credit or Guaranties: Republic National Bank v. Northwest National Bank

Republic National Bank acted as successor trustee of a cemetery's perpetual care fund.¹ The perpetual care fund contained, as one of its principal assets, a \$50,000 promissory note made payable to the fund's trustee in five equal payments by B&H Amusement Rides, Inc. (B&H). During negotiations for the sale of stock of the corporation that owned the cemetery, the prospective purchaser refused to close the sale so long as the note remained a fund asset. Consequently, B&H caused Northwest National Bank to issue, in favor of the trustee, an Irrevocable Letter of Credit² to

1. A perpetual care fund is a reserve, held in trust, with the income to maintain the cemetery's grounds and physical plant. *See* TEX. REV. CIV. STAT. ANN. art. 912a-2 (Vernon 1964).

2. The instrument was a standby letter of credit and read, in part, as follows:

2. *Drafts.* Your single draft drawn on Northwest National Bank of Fort Worth, at ten (10) days' sight, in the amount of the unpaid principal, interest and attorneys' fees then due and payable after default, pursuant to the terms of a certain Promissory Note executed January 12, 1968, by B&H Amusement Rides, Inc., payable to the order of American Cities Trust Company, which draft must state upon its face: "Drawn under Letter of Credit of the Northwest National Bank of Fort Worth, Texas, dated February 21, 1969."

4. *Purpose.* To be applied to the balance remaining on a certain loan evidenced by a certain Promissory Note executed January 12, 1968, by B&H

guarantee payment of the promissory note in the event that B&H defaulted.³ In the event of default, the letter of credit required the trustee to present specified documents to Northwest, and, upon presentation, required Northwest to pay the principal, interest, and attorneys' fees due on the note.⁴ B&H defaulted and Republic, as successor trustee, submitted to Northwest the required documents and a draft for \$45,104.75. Although the documents complied fully with the instrument's terms, Northwest refused to honor the draft, contending that the instrument constituted an *ultra vires*⁵ guaranty agreement and therefore was unenforceable against a national bank. Republic asserted that the instrument was an *intra vires*⁶ letter of credit and therefore was valid.⁷ Republic sued Northwest on the

Amusement Rides, Inc., payable to the order of American Cities Trust Company, secured by a security interest in and upon the inventory of B&H Amusement Rides, Inc.

5. *DOCUMENTS*. The required documents are:

(a) Original Promissory Note, executed January 12, 1968, by B&H Amusement Rides, Inc., payable to the order of American Cities Trust Company.

(b) Copy of letter advising B&H Amusement Rides, Inc. of default in the payment of the said note executed January 12, 1968, said advice letter being addressed to B&H Amusement Rides, Inc., showing receipt and being dated not less than twenty (20) days in advance of the date of Sight Draft.

(c) Copy of letter advising E.L. Baker, Jr., Jerome I. Weiner, and Henry W. Simon, Jr. of default in the payment of the said Note executed January 12, 1968, said advice letter being addressed in care of Simon & Simon, attorneys, 816 First National Building, Fort Worth, Texas, and being dated not less than twenty (20) days in advance of the date of Sight Draft.

(d) Copy of letter which advised owners of B&H Amusement Rides, Inc. property of default in payment and resulting acceleration of the said Promissory Note dated January 12, 1968, said letter being dated not less than twenty (20) days prior to the date of Sight Draft.

6. *OBLIGATION OF ISSUER*. The Northwest National Bank of Fort Worth, Texas, agrees with American Cities Trust Company, and/or its successor as Trustee of the Perpetual Care Fund of Crown Hill Memorial Park, a Perpetual Care Cemetery, to duly honor a proper draft drawn and negotiated in compliance with the terms of this Letter of Credit upon presentation to the office of the bank.

Reprinted at Republic Nat'l Bank v. Northwest Nat'l Bank, 578 S.W.2d 109, 111 (Tex. 1978) [hereinafter cited as the Instrument].

3. Instrument, *supra* note 2, para. 3.

4. *Id.*, paras. 2, 5.

5. A literal translation of the term is beyond, outside of, or in excess of powers granted or limited. *Black's Law Dictionary* defines the term as, "The modern technical designation in the law of corporations, of acts beyond the scope of the powers of a corporation, as defined by its charter or act of incorporation." BLACK'S LAW DICTIONARY 1692, 1742 (rev. 4th ed. 1976). See also 4 THE MICHIE CO., MICHIE ON BANKS AND BANKING ch. 7, § 33, at 48 nn.40-44 (rev. perm. ed. 1971) (*ultra vires* contract of bank is beyond its powers and void) [hereinafter cited as MICHIE].

6. "An act is said to be *intra vires* ('within the power') of a person or corporation when it is within the scope of his or its powers or authority." BLACK'S LAW DICTIONARY 958 (rev. 4th ed. 1976).

7. Traditionally, national banks have been viewed as not having authority to act as a guarantor or surety for the performance of contracts made by others. See *Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73, 77-78 (5th Cir.), *cert. denied*, 260 U.S. 701 (1922); Harfield, *The National Bank Act and Foreign Trade Practice*, 61 HARV. L. REV. 782, 788 (1948); Comment, *Recent Extensions in the Use of Commercial Letters of Credit*, 66 YALE L.J. 902, 913-14 (1957).

instrument, and the trial court held that the instrument constituted an ultra vires guaranty agreement. The court of appeals affirmed,⁸ and Republic appealed to the Texas Supreme Court. *Held, reversed*: An instrument is a letter of credit if the issuer has a primary obligation that is dependent solely upon the presentation of conforming documents and not upon the factual determination of performance or nonperformance by the parties to the underlying transaction. *Republic National Bank v. Northwest National Bank*, 578 S.W.2d 109 (Tex. 1978).

I. LETTERS OF CREDIT, GUARANTIES, AND STANDBY LETTERS OF CREDIT

A. *Letters of Credit*

A letter of credit is an instrument executed by a bank or other issuer⁹ in which the issuer promises to honor drafts or other demands for payment if the person drawing the drafts, the beneficiary, complies with the conditions specified in the instrument.¹⁰ Traditionally, letters of credit arise in the context of a contract for the sale of goods between a seller and a foreign buyer,¹¹ primarily to assure the seller of prompt payment against documents.¹² As a result, the credit of a financially solvent bank is added to

8. *Republic Nat'l Bank v. Northwest Nat'l Bank*, 566 S.W.2d 358 (Tex. Civ. App.—Fort Worth 1978).

9. An issuer is defined as a bank or other person issuing a credit. TEX. BUS. & COM. CODE ANN. § 5.103(a)(3) (Tex. UCC) (Vernon 1968). Section 24 of the National Bank Act, 12 U.S.C. § 24 (1976), sets forth limitations on the powers of national banks. To date, courts have upheld the power of national banks to issue letters of credit. *See Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73, 77-78 (5th Cir.), *cert. denied*, 260 U.S. 701 (1922); *Prudential Ins. Co. of America v. Marquette Nat'l Bank*, 419 F. Supp. 734, 735 (D. Minn. 1976). *See generally* Harfield, *supra* note 7, at 795-97. In addition, the Comptroller of the Currency (Department of the Treasury) has concluded that “[a] national bank may issue letters of credit permissible under the Uniform Commercial Code or the Uniform Customs and Practice for Documentary Credits to or on behalf of its customers.” 12 C.F.R. § 7.7016 (1979).

10. TEX. BUS. & COM. CODE ANN. § 5.103(a) (Tex. UCC) (Vernon 1968).

11. *See* J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 18-1, at 601 (1972). For example, a Danish furniture seller may insist that a New Jersey buyer procure a letter of credit issued by a bank showing seller as “beneficiary” with authority to draw drafts on the issuing bank. Should buyer agree to this mode of payment he applies to his own bank to issue an irrevocable letter of credit that commits his bank (issuer) to pay a draft drawn by seller upon seller’s proper presentation of the draft and any required documents. Seller then ships the goods and airmails the documents to the issuing bank to receive payment before the delivery of the goods. *Id.* at 604. Letters of credit have been used for centuries in international trade. W. WARD & H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 145 (4th ed. 1958); Harfield, *supra* note 7, at 790-92; Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 716 n.1 (1973).

12. *See* *Venzelos, S.A. v. Chase Manhattan Bank*, 425 F.2d 461, 464 (2d Cir. 1970). In an ordinary letter of credit transaction, when the seller ships the goods to the buyer, the seller usually obtains a bill of lading from the transporter of the goods. A bill of lading is a statement by the transporter that the goods are in his possession and that he is forwarding them to the buyer. The seller then submits to the bank his statement that he has supplied the goods contracted for (a commercial invoice), the bill of lading, and any insurance policy covering the goods. The bank will pay upon this presentation of documents to the bank. The letter of credit does not always require these documents, but may require any documents upon which the parties agree. H. HARFIELD, *BANK CREDITS AND ACCEPTANCES* 56-69 (5th ed. 1974). *See* *Anglo-South American Trust Co. v. Uhe*, 261 N.Y. 150, 184 N.E. 741,

the uncertain solvency of a foreign buyer, assuring payment regardless of whether the buyer is unable or refuses to pay.¹³

Letters of credit ordinarily arise as the third in a series of three contracts: an initial contract for the sale of goods to the bank's customer by the beneficiary, a second contract between the bank and the bank's customer in which the bank agrees to issue the letter of credit, and a third contract between the bank and the beneficiary, the letter of credit.¹⁴ This series of contracts therefore establishes the letter of credit as a separate contract that contains the sole agreement between the issuer and the beneficiary.¹⁵

To comply with safe banking practices, a letter of credit usually (1) contains a conspicuous statement designating the letter of credit as such; (2) specifies an expiration date or states a definite term; (3) limits the amount of the credit; and (4) obligates the bank to make payment only upon the presentation of a draft or other documents.¹⁶ The bank also should obligate unconditionally the bank's customer to reimburse the issuer for any payments made under the letter of credit.¹⁷ The letter of credit, however,

743 (1933). The letter of credit may also be a "clean" credit in which no documents are required and only the beneficiary's draft or demand for payment is required for payment. Note, *Guaranty Letters of Credit: Problems and Possibilities*, 16 ARIZ. L. REV. 822, 824 (1974).

13. Murray, *Letters of Credit in Nonsale of Goods Transaction*, 30 BUS. LAW. 1103, 1103 (1974). When selling goods in a foreign jurisdiction the seller faces these common risks: (1) buyer's insolvency or other inability to pay; (2) buyer's wrongful refusal to pay against documents or upon delivery; and (3) buyer's refusal to pay because one of the seller's prior shipments is nonconforming or, upon inspection, the present shipment of goods is nonconforming. The letter of credit reduces these risks by making payment due upon presentation of documents to a bank. J. WHITE & R. SUMMERS, *supra* note 11, § 18-1, at 603.

14. Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464-65 (2d Cir. 1970); see Justice, *Letters of Credit: Expectations and Frustration—Part 1*, 94 BANKING L.J. 424, 425 (1977). *But see* J. WHITE & R. SUMMERS, *supra* note 11, § 18-2. White and Summers argue that the letter of credit is not a contract and thus the issuer's obligation to honor drafts drawn by the beneficiary is not contractual. They note that the beneficiary does not enter into any agreement with the issuer; and, in fact, the issuer and the beneficiary may be wholly unknown to each other at the time the letter of credit is issued. White and Summers also argue that the letter of credit is not a third-party beneficiary contract because the claim of the beneficiary is not subject to the same defenses (*e.g.*, failure of condition and anticipatory breach) that a true third-party beneficiary's claim is generally subject to. *Id.*

15. Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 465 (2d Cir. 1970); Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 96 N.Y.S.2d 779 (Sup. Ct. 1949); Comment, *Commercial Letters of Credit: Development and Expanded Use in Modern Commercial Transactions*, 4 CUMBERLAND-SAMFORD L. REV. 134, 142 n.9 (1973). *See also* R. BRAUCHER & R. RIEGERT, *INTRODUCTION TO COMMERCIAL TRANSACTIONS* 360 (1970).

16. 12 C.F.R. § 7.7016 (1979). The bank must not be called upon to determine questions of fact or law at issue between the bank's customer and the beneficiary. *Id.* *See also* note 20 *infra* and accompanying text.

17. 12 C.F.R. § 7.7016 (1979). The Comptroller of the Currency has concluded that these factors need not be present for a national bank to honor a letter of credit. The guidelines are offered as a means of encouraging safe and sound banking practices. The Comptroller has also concluded that the legality of a letter of credit is governed solely by state statutory law, such as the Uniform Commercial Code as adopted by a state, or by convention, such as the Uniform Customs and Practices For Documentary Credits. *See* 42 Fed. Reg. 24,206 (1977) (interpretive ruling by Comptroller of the Currency). The UCC requires that: (1) the receipt must include a promise by the issuer to honor drafts or other demands for payment upon compliance with the conditions specified in the credit; (2) if the credit is issued by a bank and does not require a documentary draft or documentary demand for

need not be in any particular form.¹⁸

Since the letter of credit is a contract separate from the underlying contract between the beneficiary and the bank's customer, the bank has a primary obligation to the beneficiary.¹⁹ The bank does not determine the validity of the underlying contract or whether the contract is faithfully performed, but instead must examine the documents presented to it to determine whether the documents on their face comply with the terms of the letter of credit.²⁰ The bank must act in good faith in determining the validity of the documents and then must make payment according to its determination of the documents' validity.²¹ Should the beneficiary fail to perform the underlying contract, the bank's customer has an action against the beneficiary on the underlying contract or under section 5-111(1) of the Uniform Commercial Code.²² The bank's customer has no action against the bank unless the bank accepts noncomplying documents in bad faith and honors the draft.²³ If the specified documents comply with the terms of the letter of credit, the bank must honor the demand for payment even

payment or, although requiring neither of these, is issued by a person other than a bank and does not require that the draft or demand be accompanied by a document of title, then the letter must state conspicuously that it is a letter of credit; (3) the letter must be in writing; and (4) the letter must be signed by the issuer. TEX. BUS. & COM. CODE ANN. §§ 5.102(a), .103(a)(1), .104(a) (Tex. UCC) (Vernon 1968); J. WHITE & R. SUMMERS, *supra* note 11, § 18-4, at 615.

18. *Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73, 79 (5th Cir.), *cert. denied*, 260 U.S. 701 (1922).

19. TEX. BUS. & COM. CODE ANN. § 5.114(1), Comment 1 (Tex. UCC) (Vernon 1968); *see* *Barclay's Bank D.C.O. v. Mercantile Nat'l Bank*, 481 F.2d 1224, 1236 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974); *Asociacion de Azucareros de Guatemala v. United States Nat'l Bank*, 423 F.2d 638, 641 (9th Cir. 1970).

20. *Asociacion de Azucareros de Guatemala v. United States Nat'l Bank*, 423 F.2d 638, 641 (9th Cir. 1970); *see* *Banco Espanol de Credito v. State St. Bank & Trust Co.*, 385 F.2d 230, 234 (1st Cir. 1967), *cert. denied*, 390 U.S. 1013 (1968); *Dynamics Corp. v. Citizens & S. Nat'l Bank*, 356 F. Supp. 991, 995-96 (N.D. Ga. 1973).

21. TEX. BUS. & COM. CODE ANN. § 5.114, Comment 1 (Tex. UCC) (Vernon 1968).

22. *Id.*, Comment 2. *See also* *Bossier Bank & Trust Co. v. Union Planters Nat'l Bank*, 550 F.2d 1077 (6th Cir. 1977).

23. TEX. BUS. & COM. CODE ANN. § 5.114(b) (Tex. UCC) (Vernon 1968) states:

Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7.507) or of a security (Section 8.306) or is forged or fraudulent or there is fraud in the transaction

(1) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3.302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7.502) or a bona fide purchaser of a security (Section 8.302); and

(2) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment 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.

By implication, the issuer may refuse to honor a draft if (1) the required documents do not conform to warranties made on negotiation or transfer of a document of title or of a security, (2) the required document is forged or fraudulent, or (3) there is fraud in the transaction, provided that the party demanding payment is not a holder in due course or a person to

if the bank's customer directs the bank not to honor the draft.²⁴ Generally, the bank may dishonor the demand only when the documents fail to comply with the terms of the letter or when the documents are fraudulently presented.²⁵

B. *Guaranties*

A guaranty is a contractual undertaking by one person, the guarantor, to answer for payment of a debt or performance of a contract or duty in case of the default of another person, the principal, who is liable for such payment or performance in the first instance.²⁶ The principal undertakes a primary, unconditional promise to a third party, the creditor or guaranteee.²⁷ The guarantor then undertakes a secondary promise to the guaranteee, expressly conditional upon the principal's nonperformance of his primary duty to the guaranteee.²⁸ As a general rule, the liability of the guarantor is measured by the liability of the principal to the guaranteee.²⁹ Therefore, upon nonperformance by the principal, the guarantor may avoid secondary liability under the guaranty contract if the principal is not bound under the principal contract to perform.³⁰ Where, under the conditions of the contract between the principal and the guaranteee, no liability has arisen on the part of the principal, there is no liability on the part of the guarantor.³¹ Hence, where the principal's duty is conditioned upon an

whom a document of title has been duly negotiated, or a bona fide purchaser of a security. J. WHITE & R. SUMMERS, *supra* note 11, § 18-6, at 624.

A forged document includes forged signatures, and a fraudulent document is one that is specious or is materially altered. Fraud in the transaction means egregious fraud; misrepresentation as to quality is insufficient. *Id.* at 624-25.

24. J. WHITE & R. SUMMERS, *supra* note 11, § 18-6, at 620.

25. *Id.* at 620, 624.

26. See 38 AM. JUR. 2D *Guaranty* § 1, at 997 (1968); 38 C.J.S. *Guaranty* § 1, at 1130 (1943). Similar definitions abound. See, e.g., L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 6, at 10 (1950) (guarantor is one who promises either that principal will perform his duty, or that, if principal fails to do so, the guarantor will); 38 AM. JUR. 2D *Guaranty* § 2, at 997 (1968) (guarantor is one who undertakes promise that is collateral to a primary obligation on the part of the principal, which promise binds the guarantor to performance in the event of nonperformance by the principal); *accord*, Clymer v. Terry, 109 S.W. 1129, 1131 (Tex. Civ. App. 1908, no writ).

27. See L. SIMPSON, *supra* note 26, § 6, at 10; 38 AM. JUR. 2D *Guaranty* § 1, at 997 (1968); 38 C.J.S. *Guaranty* § 1, at 1130 (1943). In the law of contracts, of which the guaranty is a part, guaranteee may also be referred to as the obligee. 38 AM. JUR. 2D *Guaranty* § 1, at 995-97 (1968).

28. L. SIMPSON, *supra* note 26, § 6, at 10-11 (1950). The debtor is not a party to the guaranteee, and the guarantor is not a party to the underlying principal obligation. *Id.*

29. See 38 AM. JUR. 2D *Guaranty* § 51, at 1054-55 (1968); 38 C.J.S. *Guaranty* § 43, at 1192 (1943). The guarantor may, however, expressly assume a greater or lesser liability by the terms of the guaranty contract with the guaranteee. 38 C.J.S. *Guaranty* § 43, at 1192 (1943).

30. 38 AM. JUR. 2D *Guaranty* § 51, at 1054 (1968). Where the principal obligation is not void (such as when there is no consideration or mutual assent or where the principal contract is illegal or contrary to law), but merely unenforceable against the principal due to a defense personal to the principal, the guaranty contract is enforceable. *Id.* § 52, at 1056-57.

31. 38 C.J.S. *Guaranty* § 43, at 1192 (1943). See also L. SIMPSON, *supra* note 26, §§ 61, 62, at 292-94 (guaranteee's nonperformance of conditions precedent and impossibility of performance by principal).

executory duty of performance on the part of the guarantee, the guarantee's material failure of performance relieves the guarantor of liability on the guaranty contract.³²

When the principal does not perform, the guarantor has two choices.³³ He may determine that the underlying contract is void or unenforceable against the principal, due to the guarantee's nonperformance or breach, and refuse to honor the guaranty contract.³⁴ Alternatively, he may decide that the underlying contract is valid and enforceable against the principal and honor the guaranty contract.³⁵ If the guarantor chooses the latter course, he may then proceed against the principal for reimbursement,³⁶ with the right to be subrogated to the position of the guarantee he pays.³⁷ Since the guarantor assumes only the rights of the guarantee to the principal contract and no more,³⁸ the principal may defeat the claim with any valid defense he has against the guarantee.³⁹ In any event, the guarantor's interpretation of the underlying contract may result in litigation.⁴⁰

As a general rule, national banks lack the statutory authorization to guarantee the indebtedness of other parties.⁴¹ The prohibition stems from the National Bank Act,⁴² which does not expressly authorize banks to act as guarantors or sureties.⁴³ National banks are limited to those functions enumerated by the Act,⁴⁴ and consequently, national banks may not act as

32. L. SIMPSON, *supra* note 26, § 61, at 292. "When a creditor [guarantee] breaches his contract with the principal and varies the sureties' [guarantors'] risk he discharges the sureties [guarantors]." *Seaboard Loan Corp. v. McCall*, 61 Ga. App. 752, 7 S.E.2d 318, 319 (1940).

33. *See generally* W. WARD & H. HARFIELD, *supra* note 11, at 133-34.

34. *Id.* The guarantee may then bring an action against the guarantor on the guaranty contract. As a practical matter, this is the safest avenue for the guarantor to take. If the guarantor honors the guaranty contract absent the aid of a court decree, the likelihood of failure in a subsequent suit for reimbursement against the principal is increased. *See generally id.*

35. *Id.*

36. *Id.*; L. SIMPSON, *supra* note 26, § 48, at 224.

37. L. SIMPSON, *supra* note 26, § 47, at 205; *see* W. WARD & H. HARFIELD, *supra* note 11, at 133-34.

38. L. SIMPSON, *supra* note 26, §§ 47, 48, at 205, 224; *see* W. WARD & H. HARFIELD, *supra* note 11, at 133-34.

39. *See* W. WARD & H. HARFIELD, *supra* note 11, at 133-34.

40. *Id.*

41. *E.g.*, *Farmers & Miner's Bank v. Bluefield Nat'l Bank*, 11 F.2d 83, 85 (4th Cir.), *cert. denied*, 271 U.S. 669 (1926); *Bowen v. Needles Nat'l Bank*, 94 F. 925, 927-28 (9th Cir. 1899), *cert. denied*, 176 U.S. 682 (1900); *National Surety Corp. v. Midland Bank & Trust Co.*, 408 F. Supp. 684, 692 (D.N.J. 1976). *See* *Prudential Ins. Co. of America v. Marquette Nat'l Bank*, 419 F. Supp. 734, 735 (D. Minn. 1976); *American Empire Ins. Co. v. Hanover Nat'l Bank*, 409 F. Supp. 459, 463 (M.D. Pa. 1976). *See generally* 4 MICHIE, *supra* note 5, ch. 7, § 44, at 75-80; Harfield, *supra* note 7, at 788; Comment, *supra* note 7, at 911-12.

42. 12 U.S.C. § 24 (1976). Section 24 of the Act sets forth the corporate powers of national banks. Paragraph seven of that section empowers national banks and their agents "[t]o exercise . . . subject to law, all such incidental powers as shall be necessary to carry on the business of banking." *Id.* Immediately following this provision, however, is a list of expressly enumerated powers of national banks. *Id.*

43. *Id.*

44. *See, e.g.*, *Colorado Nat'l Bank v. Bedford*, 310 U.S. 41, 48-50 (1940) (national banks possess only the powers conferred by Congress); *Yonkers v. Downey*, 309 U.S. 590, 596 (1940) (national banks have no implied power to pledge assets as security for deposits);

guarantors or sureties.⁴⁵ The issuance of letters of credit, however, is a valid power of national banks⁴⁶ despite the absence of express authorization in the National Bank Act.⁴⁷ One commentator criticizes the distinction as inconsistent in terms of statutory authority.⁴⁸

C. Standby Letters of Credit

The letter of credit continues to be used in international sale-of-goods transactions; however, letters of credit are being used in new, nontraditional transactions as security devices in connection with transactions not involving a sale of goods.⁴⁹ In the three-contract transaction,⁵⁰ the first contract is a debt agreement between the bank's customer as obligor and the beneficiary as obligee, rather than a sale-of-goods contract between the bank's customer and the beneficiary. The standby letter of credit usually obligates the bank to the beneficiary (1) for repayment of money borrowed by, or advanced to, or for the account of, the bank's customer, or (2) for payment on account of any indebtedness undertaken by the bank's customer, or (3) for payment on account of any default by the bank's customer in the performance of the obligation.⁵¹ As a result, the standby

Texas & Pac. Ry. v. Pottorff, 291 U.S. 245, 253-54 (1934) (national banks lack power to pledge their assets to secure a private deposit). Thus, the powers specifically articulated in § 24 of the Act operate as a limitation on a national bank's corporate authority. The incidental powers granted by the Act, *see* note 42 *supra*, work in the opposite direction.

The rule that banks' powers are limited to those prescribed by statute was first expressed in *Curtis v. Leavitt*, 15 N.Y. 9, 52 (1857), the first case to interpret the New York Banking Act of 1838. Despite the absence of express statutory authorization, however, the court upheld the authority of a bank to borrow money, emphasizing that such authority was incidental and necessary to the exercise of expressly granted powers. *Id.* at 52-53; *see* Harfield, *supra* note 7, at 799, in which it is stated:

The doctrine of the *Curtis* case . . . is that when an organic statute refers to a particular business, the history and current practices of that business furnish the test of proper conduct, and a recital of techniques does not exclude the employment of other techniques notwithstanding the maxim, *expressio unius est exclusio alterius*.

(Footnote omitted.)

45. *See* note 41 *supra* and accompanying text. State banks have no greater powers of guaranty than national banks. 4 MICHIE, *supra* note 5, ch. 7, § 44, at 80. The Texas Banking Department Self-Support and Administration Act, which sets forth the function and powers of state incorporated banks, is similar to the National Bank Act. *Compare* TEX. REV. CIV. STAT. ANN. art. 342-301 (Vernon 1973) with 12 U.S.C. § 24 (1976). Texas courts adhere to the rule that banks cannot act as guarantors. *See* *Farmers' State Bank v. First State Bank*, 260 S.W. 664 (Tex. Civ. App.—El Paso 1924, writ ref'd); *First State Bank v. Sanford*, 255 S.W. 644 (Tex. Civ. App.—Dallas 1923, no writ).

46. *E.g.*, *Border Nat'l Bank v. American Nat'l Bank*, 282 F. 73, 77-78 (5th Cir.), *cert. denied*, 260 U.S. 701 (1922); *Prudential Ins. Co. of America v. Marquette Nat'l Bank*, 419 F. Supp. 734, 735 (D. Minn. 1976); *see* note 9 *supra*.

47. 12 U.S.C. § 24 (1976).

48. Harfield, *supra* note 7, at 788-90. Harfield does not dispute the distinction itself; instead, he argues that the rationale for such a distinction is better found in an analysis of sound banking practices and the history of the banking industry. *Id.*

49. *See generally* Murray, *supra* note 13, at 1103; Verkuil, *supra* note 11, at 717, 721; Comment, *supra* note 7, at 902.

50. *See* notes 14-15 *supra* and accompanying text.

51. *See* Venizelos, S.A. v. Chase Manhattan Bank, 425 F.2d 461, 464-65 (2d Cir. 1970); R. BRAUCHER & R. RIEGERT, *supra* note 15, at 360. *See also* *Bossier Bank & Trust Co. v. Union Planters Nat'l Bank*, 550 F.2d 1077 (6th Cir. 1977); *Baker v. National Blvd. Bank*, 399

credit is in substance a guaranty, but in form a letter of credit.⁵²

Although standby letters of credit take the same basic form as traditional letters of credit and must meet the same requirements under the Uniform Commercial Code,⁵³ important differences separate the two. Since standby letters of credit are based upon debt obligations, which may arise from an infinite variety of commercial transactions,⁵⁴ the nature of the documents that the beneficiary must present to the issuer to obtain payment has been altered radically.⁵⁵ In addition, standby letters of credit create a contingency element not present in the traditional letter of credit transaction. In the latter, the bank expects the beneficiary to draw upon the credit when the goods are shipped to the bank's customer; in standby letters of credit transactions, however, the bank expects the beneficiary to draw upon the credit only if the bank's customer defaults on the debt obligation.⁵⁶ Finally, the risks associated with the issuance of standby letters of credit as opposed to traditional letters of credit are different. One commentator argues that an issuer of a credit is less exposed to loss in the sale of goods context because he receives documents of title to the goods as a precondition to payment to the beneficiary.⁵⁷ In the standby letter of credit context, an issuer retains no such security interest and must proceed against its customer who has already defaulted on the underlying obligation.⁵⁸ Another commentator, however, rejects the proposition that the issuer of a traditional letter of credit retains any material security by virtue of the documents of title.⁵⁹ He argues that the issuer (usually a bank) sel-

F. Supp. 1021 (N.D. Ill. 1975). The standby letter of credit may also be used to guarantee performance in a construction contract. The letter of credit would be payable against the beneficiary-owner's affidavit evidencing the contractor's default. Note, *supra* note 12, at 826. Letters of credit may also be used to support the issuance of commercial paper. The bank adds its credit to that of the issuing corporation, making the commercial paper more marketable. Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C.L.J. 251, 253 (1972).

52. 12 C.F.R. § 7.1160(a) (1979).

53. See *Bossier Bank & Trust Co. v. Union Planters Nat'l Bank*, 550 F.2d 1077 (6th Cir. 1977); *Barclays Bank D.C.O. v. Mercantile Nat'l Bank*, 181 F.2d 1224 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974); 12 C.F.R. §§ 7.1160(a), 7.7016 (1979).

54. For a discussion of the validity of transactions in which a standby credit has been utilized as a security device, see Murray, *supra* note 13, at 1104-05; Verkuil, *supra* note 11, at 717; Comment, *supra* note 7, at 903-09.

55. TEX. BUS. & COM. CODE ANN. § 5.102, Comment 1 (Tex. UCC) (Vernon 1968). See Verkuil, *supra* note 11, at 718; Comment, *supra* note 7, at 910. Some examples of documents that may be required are written notice of a customer's default, a third party certificate of nonperformance, or an architect's certificate or other written notification of completion of construction. Verkuil, *supra* note 11, at 718, 722, 723.

56. See Harfield, *supra* note 7, at 258-59; Verkuil, *supra* note 11, at 723.

57. Verkuil, *supra* note 11, at 721, 723, 727-28. Verkuil argues that the issuer retains a security interest in the documents. In addition, if a bank is the issuer it may debit its customer's account as a result of the security interest. *Id.* at 721.

58. *Id.* at 723. This analysis, however, ignores instances such as those in *Republic Nat'l Bank v. Northwest Nat'l Bank*, in which the issuer had a security interest in the assets of the bank's customer. It also ignores that letters of credit may be "clean" credits, where the letter of credit has a sale-of-goods contract underlying it but the bank has no security interest in the goods since it receives no documents. See note 12 *supra*. The risks involved have been altered by changes in banking regulations. See notes 85-92 *supra* and accompanying text.

59. Harfield, *The Standby Letter of Credit Debate*, 94 BANKING L.J. 298, 298-99 (1977).

dom retains the documents in the usual transaction.⁶⁰ In any event, both commentators agree that the issuer of a standby credit is less likely to be reimbursed for honoring the letter of credit than the issuer of a traditional letter of credit because the fact that the bank must pay under the standby credit suggests that the customer is not at that time able to meet his current liabilities.⁶¹

II. REPUBLIC NATIONAL BANK V. NORTHWEST NATIONAL BANK

The Texas Supreme Court confronted the question of whether standby letters of credit are to be considered letters of credit or guaranties. The Irrevocable Letter of Credit issued by Northwest provided that, should B&H default upon its promissory note to the cemetery's perpetual care fund, the trustee could draw on the letter of credit from Northwest in the amount of the unpaid principal and interest by presenting to Northwest the original promissory note along with copies of letters to B&H and its attorneys notifying them of default on the note.⁶² Republic contended that the instrument was a valid letter of credit and argued that, as such, Northwest's duty to honor the draft arose upon the presentation of the documents. Northwest contended that the instrument in substance was a guaranty because Northwest's liability arose only upon the default of B&H and, like a guaranty, acted as a secondary source of payment. The court noted that all letters of credit, even the traditional ones, appear to serve as guaranties.⁶³ In a traditional letter of credit, in which the underlying contract is for the sale of goods, the bank guarantees payment once the goods are shipped and the documents presented to the bank. Whether an instrument is a true letter of credit or a guaranty, therefore, does not rest on the credit's function. It follows that the type of underlying contract, whether a sale-of-goods transaction or a debt obligation, is unimportant in determining whether an instrument is a true letter of credit.⁶⁴

Rather than determining the validity of the standby letter of credit on an analysis of the type of underlying contract, the court examined the nature of the obligation the issuer had to the beneficiary and the context in which that obligation arose. In traditional letters of credit, the issuer has a pri-

60. *Id.* at 299.

61. *Id.*; Verkuil, *supra* note 11, at 723-24. Harfield suggests "[i]t is entirely possible, however, that a pure guaranty credit may be a sounder transaction than a classic eligible credit, if the banker has taken the precaution of obtaining collateral for the customer's obligation to reimburse him." Harfield, *supra* note 59, at 299-300.

62. See Instrument, *supra* note 2, paras. 2, 5.

63. 578 S.W.2d at 114. The court quoted Harfield, *Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92 (1962), in which Harfield stated:

A letter of credit always serves as a guaranty. This does not mean that it is a guaranty. A letter of credit is an identical twin to a guaranty, but the fact that the two things look alike and may be used for the same purpose and are difficult to distinguish one from the other . . . does not mean that there are not differences, which, however subtle, are of major importance.

Id. at 93 (footnote omitted). See also J. Halls, *The Uniform Commercial Code in Minnesota: Article 5—Letters of Credit*, 50 MINN. L. REV. 453, 454 n.3 (1966).

64. 578 S.W.2d at 114.

mary obligation to the beneficiary for payment under the letter of credit since the credit stands as a contract separate from the other two contracts in the three-contract transaction.⁶⁵ In a traditional guaranty agreement, the bank, as guarantor, is secondarily liable.⁶⁶ The beneficiary (obligee), therefore, must seek performance or damages from the principal before seeking performance from the guarantor.

The court relied on *Barclays Bank D.C.O. v. Mercantile National Bank*⁶⁷ in concluding that standby letters of credit are distinguishable from guaranties. In *Barclays* the Fifth Circuit emphasized comment 2 to section 5.107 of the UCC and stated that a confirming bank⁶⁸ becomes directly liable on the credit when it confirms.⁶⁹ The Fifth Circuit concluded that the type of underlying contract is unimportant to the validity of the letter of credit and to the bank's liability in that the essential element of a letter of credit is the issuer's direct liability.⁷⁰ The court, quoting section 5-107(2) of the UCC, stated that a confirming bank, by confirming the credit, becomes directly liable on the credit as though it were the issuer.⁷¹ The Texas Supreme Court, drawing support from the conclusion in *Barclays* that a confirming bank becomes directly liable as though it issued the credit,⁷² concluded that the issuer's liability is also direct.⁷³

The supreme court expressed concern about how the issuer's obligation arose. If Northwest's obligation to pay arose only upon the default of B&H, Northwest would have to determine whether default had occurred. This determination might require the bank to examine questions of fact or law concerning the underlying contract, characteristics identical to those of guaranty and unlike those of a true letter of credit.⁷⁴ For this reason the court held that an "engagement is a letter of credit [only] if the issuer has a *primary* obligation that is dependent *solely* upon presentation of conforming documents and not upon the factual performance or nonperform-

65. See notes 14 & 15 *supra* and accompanying text.

66. See notes 28-31 *supra* and accompanying text.

67. 481 F.2d 1224 (5th Cir. 1973), *cert. dismissed*, 414 U.S. 1139 (1974). In *Barclays* Allied Mortgage Co. issued a \$400,000 letter of credit in favor of Barclays Bank. The credit provided that Allied would pay any indebtedness upon proper documentation that Bay Holding Co. had failed to pay Barclays on an underlying promissory note. Mercantile confirmed the note at Allied's request. Bay Holding Co. subsequently defaulted and upon presentation of documents to Mercantile, Mercantile refused to honor the draft. The court held that the type of underlying contract made no difference; Mercantile had confirmed the note and was therefore directly liable. *Id.* at 1236, 1239.

68. A "confirming bank" is defined as a bank that engages that it will honor a credit already issued by another bank. TEX. BUS. & COM. CODE ANN. art. 5 provides that the confirming bank's obligation, to the extent of the confirmation, is that of an issuer, as is the right of reimbursement. *Id.* § 5.107(b). The most important feature of this statute is that a beneficiary who receives a confirmed credit has the independent engagements of both the issuer and the confirming bank. *Id.* § 5.107, Comment 2.

69. 481 F.2d at 1226, 1236.

70. *Id.* at 1238-39.

71. *Id.* at 1236.

72. *Id.*

73. 578 S.W.2d at 115.

74. See *id.*

ance by the parties to the underlying transaction."⁷⁵ Construing the instrument under this test,⁷⁶ the court determined that the purpose of the instrument was to pay the principal, interest, and attorneys' fees pursuant to the terms of the promissory note.⁷⁷ The court recognized that the instrument referred to the underlying transaction, but concluded that the instrument did not require Northwest to go outside the presentation of the properly drawn draft and the four specific documents to determine its liability.⁷⁸ Upon presentation, Northwest's duty was to inspect the documents on their face and to pay if the documents were correct, even if Northwest believed that no default had occurred.⁷⁹

The court cautioned, however, that national banks are not without limit to issue instruments under the guise of letters of credit,⁸⁰ citing *Wichita Eagle & Beacon Publishing Co. v. Pacific National Bank*.⁸¹ In *Wichita Eagle* the Ninth Circuit ruled that when a bank is required to examine the underlying contract before honoring its obligation to pay, the instrument strays too far from the basic purpose of letters of credit: namely, to assure prompt payment upon the presentation of conforming documents, without protracted, expensive litigation.⁸² The court recognized that by eliminating the need for the bank to police the underlying contract, expenses and litigation are minimized.⁸³ The Ninth Circuit noted that if the distinction between liability upon presentation of documents and determination of the performance of the contract is ignored, then the distinction between a letter of credit and an ordinary guaranty is obliterated.⁸⁴

75. 576 S.W.2d at 115 (emphasis in original).

76. The court observed that letters of credit are governed by the construction rules of ordinary contracts. *Id.* See *Venizelos, S.A. v. Chase Manhattan Bank*, 425 F.2d 461, 465-66 (2d Cir. 1970). See generally 6 MICHIE, *supra* note 5, ch. 12, § 31. The court stated that in Texas an instrument is generally construed most strictly against its author and in such a manner as to reach a reasonable result consistent with the intent of the parties. 578 S.W.2d at 115. If two constructions are possible, a construction making performance possible is preferred to one making performance impossible. *Id.* See *Portland Gasoline Co. v. Superior Marketing Co.*, 150 Tex. 533, 535, 243 S.W.2d 823, 824 (1951); *Monesson v. Champion Int'l Corp.*, 546 S.W.2d 631, 637 (Tex. Civ. App.—Tyler 1976, writ ref'd n.r.e.).

77. 578 S.W.2d at 116. This determination was apparently in response to Northwest's argument that para. 4 of the instrument essentially provided that the purpose of the credit was to guarantee the note and to protect payment in the event B&H defaulted on the note. *Id.* at 112; see *Instrument*, *supra* note 2, para. 2.

78. 578 S.W.2d at 116.

79. See note 17 *supra*.

80. 578 S.W.2d at 115.

81. 493 F.2d 1285 (9th Cir. 1974). In *Wichita Eagle* the lessor and lessee agreed with the sublessee that the sublessee would construct a building on the leased property. The sublessee was to provide a letter of credit, surety bond, or other form of guaranty to guarantee the construction of the building. At the sublessee's request, Pacific Bank issued a letter of credit in favor of the lessor and lessee. The lessor and lessee demanded payment from Pacific when the sublessee did not complete the building. The court refused to characterize the instrument as a letter of credit because the instrument did not specify any particular documents that were required, nor did it indicate that payment was predicated on presentation of documents. *Id.* at 1286-87.

82. *Id.* at 1286-87. In *Wichita Eagle* the court held that the instrument was an ordinary guaranty. *Id.* at 1286.

83. *Id.* at 1286-87.

84. *Id.* at 1286.

The Texas Supreme Court also discussed several commentators' concerns that recognizing standby letters of credit might jeopardize bank solvency. One concern was that banks did not realize the kind or degree of risk taken by accepting standby credits.⁸⁵ If a bank believed that it would not be required to pay and failed to assure itself of the possibility of recoupment from the bank's customer, the bank would be taking an insurance risk rather than a normal banking risk.⁸⁶ Because a bank may have assumed that the credit would never be drawn on, the bank would have been willing to grant standby credits;⁸⁷ when the credit was drawn on, however, it was usually accompanied by the customer's insolvency.⁸⁸ Also, letters of credit traditionally have been treated as contingent liabilities and not listed on a bank's balance sheet, which bank regulators examine to determine a bank's solvency.⁸⁹ The court dismissed these concerns, observing that current federal regulations regard standby letters of credit as the functional equivalent of loans and make standby credits subject to the bank's statutory lending limits.⁹⁰ Regulations also require banks to make a credit analysis of the bank's customer comparable to one required for an ordinary loan.⁹¹ In the court's opinion, these regulations adequately safeguard bank solvency.⁹² By holding in favor of Republic, however, the Supreme Court of Texas tacitly has accepted standby letters of credit as valid letters of credit.

III. CONCLUSION

In *Republic National Bank v. Northwest National Bank* the Texas Supreme Court held that the instrument issued by Northwest qualified as an enforceable and intra vires letter of credit. To reach this conclusion, the court held that under article 5 of the Uniform Commercial Code as adopted by Texas an instrument is a true letter of credit if the bank has a primary obligation that is dependent solely upon presentation of conforming documents and not upon the determination of performance or nonperformance by the parties to the underlying transaction. In so hold-

85. 578 S.W.2d at 114; see Verkuil, *supra* note 11, at 727-29; Note, *supra* note 12, at 831-33.

86. R. BRAUCHER & R. RIEGERT, *supra* note 15, at 375.

87. See note 61 *supra* and accompanying text.

88. Note, *supra* note 12, at 832.

89. Verkuil, *supra* note 11, at 727.

90. 12 C.F.R. § 7.1160(b) (1978). The Federal Reserve Board and the Federal Deposit Insurance Corporation have similar requirements. 12 C.F.R. § 208.8(d)(2) (1978) (Federal Reserve Board); 12 C.F.R. § 337.2(b) (1978) (FDIC).

91. 12 C.F.R. § 208.8(d)(2)(ii) (1978).

92. 578 S.W.2d at 114. One commentator, however, argues that the regulations are inadequate as they should also require aggregation of lending limits by looking through to the ultimate user of the credit. Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697, 705 (1975). Senator Edward Brooke also did not agree that the Comptroller's ruling was adequate to protect bank solvency. Senator Brooke would have amended the National Bank Act to provide that a bank's liability on standby letters of credit would be limited to its entire capital stock, plus 50% of its unimpaired surplus. The legal limitation on loans to a single borrower of 10% of the bank's capital and surplus would also be made applicable. *Id.* at 712.

ing, the court recognized that while standby credits may function as guaranties, they avoid the possibility of expensive, protracted litigation that accompanies guaranties. The decision allows the flexibility envisioned by the UCC drafters, while avoiding undue risk to the issuing bank. The court will recognize an instrument as a valid letter of credit if it meets the court's test, unless the court determines that the instrument is disguised as a letter of credit in order to serve a purpose at variance with the basic purpose of a letter of credit.

Tim A. Forgeron