ARTICLE

REMEMBERING THE BAY OF PIGS: USING LETTERS OF CREDIT TO FACILITATE THE RESOLUTION OF INTERNATIONAL DISPUTES

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It is a maxim founded on the universal experience of mankind that no nation is to be trusted farther than it is bound by its interest. 

George Washington

INTRODUCTION

It is a sad commentary that international conflicts may be resolved more easily with letters of credit than with trust. The 1962 dispute between the United States and Cuba over the release of the Bay of Pigs prisoners is a textbook example of this principle. The agreement to exchange prisoners for food and medicine was only made possible by a letter of credit issued by The Royal Bank of Canada.

This Article examines the unique features of letters of credit and the part they can play in the resolution of nation-to-nation disputes and/or disputes involving nations and non-governmental organizations. Part I of the Article describes the two main types of letters of credit (commercial and standby) and examines those characteristics which make them effective mechanisms for facilitating the resolution of international disputes. Part II examines the standby letter of credit used in resolving the Cuba—United States Bay of Pigs crisis. Using the Bay of Pigs credit as a model, Part III describes types of international conflicts where standby letters of credit can facilitate dispute resolution. Part IV analyzes the different role played by commercial letters of credit in implementing the 1996-2003 Iraqi Oil for Food Program. Using the

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Iraqi credits as a model, Part V describes types of international disputes where commercial letters of credit could facilitate international settlements.

I. COMMERCIAL AND STANDBY LETTERS OF CREDIT

There are two main types of letters of credit: the commercial, or trade, letter of credit and the standby, or “guarantee,” letter of credit.

A. The Commercial Letter of Credit

The word “commercial” is derived from “merx,” the Latin word for “goods.” The concept of “goods” fairly well summarizes the nature of a commercial letter of credit; it is a mechanism traditionally used to pay for goods in international sale transactions. To understand how the commercial letter of credit functions in these sale transactions, it would be helpful to describe the typical three-contract structure of the commercial letter of credit transaction.

A seller in Bordeaux, France, and a buyer in Los Angeles, California, enter into a contract for the sale of 7,000 cases of wine for a price of $2 million. The sale contract includes terms covering, inter alia, the quantity of wine being sold (7,000 cases), the price of the wine ($2 million), the time of delivery, risk of loss, the warranties provided by the seller, and applicable choice of law and choice of forum provisions. If the price is to be paid through a letter of credit, then the contract will also include a payment term

2 The traveler’s letter of credit is a third type of letter of credit wherein the applicant for the credit is also the named beneficiary of the credit. The beneficiary can draw on the credit and receive payments of money at foreign or domestic correspondents of the issuing bank. See Ufitec, S.A. v. Trade Bank & Trust Co., 249 N.Y.S.2d 557, 559 (1964), aff’d, 16 N.Y.2d 698 (1965). These types of credits were largely developed during the Crusades by the Knights Templar as a way of allowing Christian pilgrims to finance their journey to Palestine. See Edward Burman, The Templars: Knights of God 76-97 (1986). Credit cards have largely replaced the traveler’s credit.

3 The word “guarantee” must be placed in quotes because from a legal perspective, a letter of credit is not a guarantee. A letter of credit is a primary payment obligation and a guarantee is a secondary payment obligation. See John F. Dolan, The Law of Letters of Credit: Commercial and Standby Credits 12-30 (2003). Foreign banks, however, often issue what are called “first demand guarantees.” These guarantees are primary payment obligations and are the equivalents of standby letters of credit. Id. at 1-31.

4 This underlying sales contact will be governed by one of three possible bodies of law: French law, the United Nations Convention on Contracts for the International Sale of Goods, or U.C.C. Article 2.
requiring the Los Angeles buyer to request Solid Gold Bank, a Los Angeles bank of known international standing, to open a commercial letter of credit in favor of the Bordeaux seller for the $2 million purchase price of the wine. This contract between seller and buyer for the sale of the 7,000 cases of wine is the underlying agreement on which two other contracts will be built. For the purposes of this Article, this underlying contract between the seller in Bordeaux and the buyer in Los Angeles will be labeled Contract I.

The buyer now requests Solid Gold Bank to open the $2 million commercial letter of credit in favor of the seller in Bordeaux. The Buyer applies for the issuance of the credit by filling out Solid Gold Bank’s pre-printed form entitled “Application and Agreement for the Issuance of a Commercial Letter of Credit.” The front of the form, the application, asks the buyer to provide pertinent information about the letter of credit transaction such as the name of the seller-beneficiary of the credit, the amount of the credit, and the desired expiration date of the credit. Most important, the application requires the buyer to specify both the form of draft and the shipping documents that Solid Gold Bank must receive before honoring its letter of credit obligation. Typically, these shipping documents will include: an invoice in multiple copies; a transport document such as an ocean bill of lading or an airway bill; an insurance certificate insuring shipment of the wine from Bordeaux to Los Angeles; and perhaps an inspection certificate and/or a consular invoice.

On the back of the pre-printed form is a reimbursement agreement in which the buyer promises to reimburse the issuer of the credit, Solid Gold Bank, for any payments made under the credit and secures its reimbursement obligation by granting Solid Gold Bank a security interest in the goods and shipping documents generated by the sale transaction. This reimbursement agreement between the buyer-applicant and the issuing bank will be labeled Contract II.

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5 For a copy of a standard commercial letter of credit application form, see BROOKE WUNNICKE ET AL., STANDBY AND COMMERCIAL LETTERS OF CREDIT 16-6 (2003).

6 A draft is normally required to trigger payment of the issuer’s letter of credit obligation. A draft can be payable at sight (U.C.C. § 3-108(a)) or at a specified number of days after sight (U.C.C. § 3-409 (a),(c)). A draft payable a specified number of days after sight is sometimes referred to as a usance draft. See DOLAN, supra note 3, at G-42. Deferred payment credits, however, are usually payable without the submission of a draft. See Gerald T. McLaughlin, Should Deferred Payment Letters of Credit Be Specifically Treated in a Revision of Article 5?, 56 BROOK. L. REV. 149 (1990).


8 For a copy of a standard commercial letter of credit reimbursement agreement, see WUNNICKE ET AL., supra note 5, at 12-16.
If it agrees to issue the credit, Solid Gold Bank will open the requisite $2 million letter of credit in favor of the seller-beneficiary in Bordeaux. Typically Solid Gold Bank will simply transpose the information from the buyer’s application form into its letter of credit format, mark the credit as irrevocable,\(^9\) and forward it to the seller-beneficiary in Bordeaux. The letter of credit (Contract III) obligates issuer Solid Gold Bank to pay $2 million upon the seller-beneficiary’s presentation of the required form of draft and shipping documents listed in the letter of credit.\(^{10}\)

Solid Gold Bank will normally route its commercial letter of credit to the seller-beneficiary through a Bordeaux bank which will either advise or confirm the credit. The distinction between these two functions is important. If the Bordeaux Bank simply advises the credit, then it delivers Solid Gold Bank’s letter of credit to seller-beneficiary without adding its own payment obligation to it.\(^{11}\) In this case, the seller-beneficiary receives only one bank payment obligation, that of issuer Solid Gold Bank. If, however, the Bordeaux bank confirms the letter of credit, then it delivers the credit with its own independent payment obligation added to that of issuer Solid Gold Bank.\(^{12}\) Consequently, the beneficiary receives two separate bank obligations, either of which can be drawn on to collect the $2 million purchase price of the wine. If there is a confirming bank, then the typical three-contract model of a letter of credit transaction must be enlarged to a four-contract model. The Bordeaux confirming bank’s payment obligation owed the seller-beneficiary of the credit will be labeled Contract IV.

In a smoothly working transaction where there is an advising bank but no confirming bank, the French seller-beneficiary gathers the requisite shipping documents and presents them to the advising bank for transmittal to issuer Solid Gold Bank in Los Angeles. If Solid Gold Bank finds them to be in strict compliance with the terms and conditions of the credit,\(^{13}\) the it will “buy the

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\(^9\) Letters of credit are irrevocable unless they provide otherwise. U.C.C. § 5-106(a) (2003); PUB. NO. 500, UNIFORM CUSTOMS & PRACTICE FOR DOCUMENTARY CREDITS, art. 8(c) (1993) [hereinafter UCP].

\(^{10}\) For a basic form of commercial letter of credit, see WUNNICKE ET AL., supra note 5, at 16-7.


\(^{13}\) See id. § 5-108(a). The strict compliance standard has been adopted by the Official Text of Revised U.C.C. Article 5. On the rejected standard of “substantial compliance” see the discussion and the cases cited in Official Comment 1 to U.C.C. § 5-108.
documents" from the seller-beneficiary. Once reimbursed under Contract II, Solid Gold Bank will turn the purchased documents over to buyer-applicant. When the wine arrives in Los Angeles, buyer-applicant will present the bill of lading to the carrier and claim the goods. The letter of credit has now served its purpose. The seller-beneficiary has been paid $2 million by Solid Gold Bank, Solid Gold Bank has been reimbursed for that amount by buyer-applicant, and buyer-applicant has received 7,000 cases of wine. Upon inspection, if there are any problems with the quality of the wine, the buyer must seek a remedy against seller under Contract I.\textsuperscript{14}

If there is a confirming bank in the transaction, the Bordeaux seller will most likely present the shipping documents to the Bordeaux confirming bank for purchase under Contract IV. The Bordeaux bank will buy the shipping documents and then forward them to Solid Gold Bank with a request for reimbursement.\textsuperscript{15} If, in its judgment, the documents strictly comply with the terms and conditions of the credit, Solid Gold Bank will reimburse the Bordeaux confirming bank and then seek reimbursement from buyer-applicant under Contract II. Once reimbursed, Solid Gold Bank will release the shipping documents to buyer-applicant so it can lay claim to the wine when it arrives in Los Angeles.

Several aspects of this three/four-contract structure of a commercial letter of credit transaction should be noted.

First, commercial letters of credit are alternative, not substitute, bank payment obligations. Contrast a letter of credit with a different form of bank payment obligation—the cashier's check.\textsuperscript{16} If the seller in Bordeaux were to accept Solid Gold Bank's cashier's check as payment for the wine, the seller would no longer have recourse against the buyer for the $2 million purchase price. The cashier's check is a substitute payment mechanism that totally

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\textsuperscript{14} It is helpful to keep the names of the parties to each of the three/four contracts separate for purposes of analysis. Disputes over the terms of the contract for sale (Contract I) are between seller and buyer. Disputes over reimbursement and issuer's security interest in collateral (Contract II) are between the applicant for the credit (buyer) and the issuer of the credit. Disputes over paying the letter of credit and documentary discrepancies (Contract III) are between beneficiary (seller) and the issuer of the credit. Finally, disputes over payment of a confirmation (Contract IV) are between the beneficiary and the confirmer of the credit.

\textsuperscript{15} Under U.C.C. Article 5, a confirmer is a nominated person. U.C.C. § 5-102(a)(4) (2003). An issuer undertakes by agreement or custom to reimburse a nominated person (and therefore a confirmer) for any payments made by the nominated person. Id. § 5-102(a)(11).

\textsuperscript{16} A cashier's check is a check where both the drawer and the drawee are the same bank or branches of the same bank. See id. § 3-104(g).
replaces the buyer's payment obligation. The commercial credit, on the other hand, simply adds the issuer's payment obligation to that of the buyer-applicant. The seller-beneficiary still has recourse against the buyer-applicant under Contract I, but only after Solid Gold Bank dishonors its Contract III payment obligation.  

Although Solid Gold Bank's payment obligation under Contract III does not permanently eliminate the buyer-applicant's liability for the price of the wine under Contract I, it does temporarily suspend the buyer's Contract I liability. Section 2-325(a) of the proposed Revision of Article 2 of the U.C.C. provides that "[i]f the parties agree that the primary method of payment [for goods in a contract for sale] will be by letter of credit... the buyer's obligation to pay is suspended by seasonable delivery to the seller of a letter of credit."

Because the Bordeaux seller and the Los Angeles buyer intended that Solid Gold Bank's letter of credit would be the primary method of payment for the wine, the issuance of the Bank's commercial credit suspended, but did not eliminate, buyer's Contract I payment liability. If Solid Gold Bank dishonors its Contract III payment obligation, then buyer's Contract I liability is no longer suspended and the beneficiary-seller can sue either Solid Gold Bank for wrongful dishonor of its payment obligation under Contract III or, upon seasonable notice, "require payment directly from the buyer" under Contract I.

Second, Solid Gold Bank's letter of credit (and Bordeaux Bank's confirmation) represents a "contract" between the bank and the seller-beneficiary. This contract (Contract III) obligates Solid Gold Bank to pay the seller-beneficiary if the seller-beneficiary presents specified documents before the expiration date of the credit. This "contract," however, is not a typical bilateral contract that developed out of the common law but is a "specialty contract" that developed out of the law merchant. The "special" rules that apply to letters of credit (confirmations), particularly rules that restrict alienability, eliminate

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17 Id. § 3-310(a).
18 See id. § 2-325(2); see also id. § 2-325(c) (proposed Final Draft 2003) [hereinafter ALI].
19 ALI, supra note 18.
20 Id.; see also U.C.C. § 2-325(2) (2003).
21 The letter of credit... arises from the law merchant and is a creature of merchants and bankers, and not of lawyers. Consequently, the letter of credit does not fit well into the law of contract... Being a specialty, the letter of credit needs the unique protection that the law merchant customarily has afforded to specialties.

22 U.C.C. § 5-112 (2003); id. cmt. 1.
the need for consideration, and require strict enforcement of payment conditions and independence from related transactions, make them effective tools in helping to resolve disputes.

Third, the three/four-contract structure of a commercial letter of credit transaction is at base a method of risk allocation. In an international sale contract, the seller who ships goods to the buyer on credit bears the risk that buyer will not be able to pay for the goods when they arrive at their destination point (the so-called insolvency risk). Similarly, the seller who ships on credit bears the risk that when the goods arrive, the buyer may act fraudulently and demand a reduction in the price of the goods (the so-called dishonesty risk). A commercial letter of credit shifts these risks from the seller to the issuing bank. Once a letter of credit has been opened, the seller need not worry about the financial health of the buyer because issuer Solid Gold Bank, a major banking institution, is obligated to pay for the wine. Once the credit has been issued, the seller also need not be concerned by the buyer’s attempts to force seller to accept a price reduction. Again, Solid Gold Bank is obligated to pay the seller-beneficiary for the wine and will not jeopardize its reputation in banking circles by acting dishonestly towards its letter of credit beneficiaries.

Finally, the confirmation (Contract IV) shifts the sovereign risk from the seller to the Bordeaux confirming bank. If for any reason, the United States were to block Solid Gold Bank from paying French nationals, the seller would obtain payment by drawing on the Bordeaux bank’s confirmation (Contract IV). United States regulations blocking American banks from paying French nationals would not extend to local French banking institutions such as Bordeaux confirming bank.

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23 Id. § 5-105.
24 Id. § 5-108(a) (strict documentary compliance).
25 Id. § 5-103(d).
26 See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 697-99 (5th ed. 2000) (noting that the commercial letter of credit also shifts the risk that buyer would delay payment because of an honest dispute over the quality of the goods from the seller to the issuer of the credit. Normally the credit will be paid long before the buyer inspects the goods themselves.).
27 The French confirming bank would then seek reimbursement from Solid Gold Bank but would not be able to recover because of the U.S. blocking regulations.
B. The Standby Letter of Credit

If commercial letters of credit are used in sales of goods transactions, standby letters of credit are used in non-sales transactions.28 One of the oldest uses of standby credits is as a backup payment obligation in a commercial loan transaction.

A creditor and a debtor enter into a loan agreement (Contract I) whereby the creditor agrees to lend the debtor $50 million repayable on June 10. In the loan agreement, the creditor requires that the debtor secure its Contract I repayment obligation by having Local Bank29 open a standby letter of credit in the creditor's favor. The debtor applies to Local Bank by filling out the Local Bank's pre-printed "Application and Agreement for the Issuance of a Standby Letter of Credit."30 In the application portion of the form, the debtor will specify information about the desired letter of credit, such as the name of the creditor-beneficiary, the form of the required draft, the amount of the credit, and the expiration date of the credit.31

The application also asks the debtor to specify the form of draft and financial documents which Local Bank must obtain before honoring its payment obligation. Although payment of a commercial letter of credit is normally triggered by the presentation of shipping documents such as an invoice and a bill of lading, payment of a standby credit is often triggered by presentation of nothing more than a certificate of default signed by the beneficiary certifying that the debtor has failed to perform its Contract I obligation, in this case repayment of the loan by June 10th.

If Local Bank agrees to issue the credit, it will sign the application form. On the back of the form is the reimbursement agreement (Contract II), whereby the debtor agrees to reimburse Local Bank for any amounts paid under the standby credit.32 Local Bank then transposes the relevant information from the application to its letter of credit format and issues an irrevocable standby credit to the creditor-beneficiary (Contract III). In this case, the creditor-beneficiary can draw on the credit by presenting a certificate attesting to the debtor's failure to repay the $50 million by June 10th.

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28 See WUNNICKE ET AL., supra note 5, at 2-8 to -9.
29 Because standby credits are frequently used in domestic transactions, there is often no need for a major international bank to issue the credit.
30 See WUNNICKE ET AL., supra note 5, at 13-6 (showing an example of a standby letter of credit application form).
31 Id.
32 See id. at 12-28, 12-34.
Several comments should be made about this three-contract standby letter of credit structure. First, as shown above, a commercial letter of credit suspends the applicant’s Contract I payment obligation until after the issuer of the credit dishonors its Contract III payment obligation. The opposite occurs with the typical standby letter of credit. The applicant’s failure to meet its Contract I payment obligation triggers the issuer’s Contract III payment obligation. In the standby context, when there is a breach of the debtor’s Contract I obligation, the creditor-beneficiary can either immediately pursue its remedies against the debtor under Contract I or seek to recover from the issuer under its Contract III backup payment obligation.

Second, a commercial letter of credit transaction is self-collateralized, meaning the shipping documents generated by the sale transaction have intrinsic value: they represent 7000 chests of wine. Consequently, when Solid Gold Bank obtains a security interest in the shipping documents, it receives an interest in valuable collateral.

A standby letter of credit transaction, however, is not self-collateralized. The typical document generated in the standby transaction, the certificate of default, has no intrinsic value. Therefore, if Local Bank wishes the debtor to collateralize its Contract II reimbursement obligation, the debtor will have to provide the Bank with collateral that is unrelated to the loan transaction. The adequacy and liquidity of this collateral will most likely determine whether Local Bank will agree to issue the $50 million standby credit. If the standby credit is drawn on, it means the debtor cannot repay the loan under Contract I. Local Bank will have to meet its Contract III obligation and seek reimbursement from the debtor under Contract II. If the debtor was unable to repay the loan under Contract I, it is unlikely to be able to meet its reimbursement obligation under Contract II. In the end, Local Bank will have to rely on the collateral to be made whole.

**C. Relevant Rules of Letter of Credit Law**

Certain “specialty contract” rules make the letter of credit payment mechanism amenable to use in settling political disputes.

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33 See supra note 18 and accompanying text.
34 WHITE & SUMMERS, supra note 26, at 699.
35 Id.
1. Documentary Payment Conditions

Letters of credit are documentary payment mechanisms. This means that the Contract III payment obligation undertaken by commercial or standby issuers must be triggered by the presentation of a piece of paper, not by the happening of an event. A standby letter of credit, for example, may condition payment upon the presentation of a certificate attesting to the default of the debtor but not on the actual default of the debtor. Similarly, a commercial letter of credit may condition payment upon the presentation of a written statement that the goods have been shipped in a refrigerated vessel but not on the fact that the goods were shipped in a refrigerated vessel.

Article 4 of the **Uniform Customs and Practice for Documentary Credits** (UCP), a set of rules that are incorporated by reference into virtually every letter of credit opened by bank issuers, states this principle well. "In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate."

The documentary obligation undertaken by issuers of letters of credit is what keeps letters of credit swift and certain payment mechanisms. If an issuer had to resolve factual disputes relating to holder-in-due-course status or factual disputes relating to the quality or shipment of the goods, payments under letters of credit would necessarily be delayed and the value of the mechanism devalued.

2. Strict Compliance

If the terms of a letter of credit must condition payment against the presentation of documents, not the facts to which these documents relate, then there must be a standard that compares the conformity of the documents presented with the terms and conditions of the letter of credit. The almost universally accepted standard of documentary compliance is the standard of strict compliance. Strict compliance, however, does not mean mirror image compliance. Trivial discrepancies, such as the misspelling of the name Mary

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36 See U.C.P. art. 4 (1993). If a letter of credit is drafted in such a way as to condition payment against so-called non-documentary conditions, the issuer “shall” disregard such conditions and treat them as if they had never been stated in the credit. U.C.C. § 5-108(g) (2003); U.C.P. art. 13(c) (1993); see also Official Comment 6 to U.C.C. § 5-102 (2003).
38 “Strict compliance does not mean slavish conformity to the terms of the letter of credit.”
Smith as Mary Smithh, will not violate the strict compliance standard but the substitution of the name Mary Smythe for Mary Smith certainly would. Although there is some leaven in the doctrine of strict construction, letter of credit issuers are not required to make educated guesses as to the equivalency of language. Like the requirement of documentary payment conditions, the standard of strict compliance keeps the letter of credit a swift and certain payment mechanism.

 Parties, particularly parties to a standby letter of credit transaction, can significantly reduce challenges to the facial conformity of letter of credit documents by stipulating in advance the precise language of those documents. The form of the required certificate of default, for example, can be attached to the letter of credit. To demand payment, the beneficiary need only sign and date it.

 A so-called "clean" letter of credit conditions payment on the presentation of a simple sight draft without any accompanying documents. A draft is a document for the purposes of U.C.C. Article 5. Using "clean" credits whenever possible also reduces the number of strict compliance challenges. Unlike certificates of default, the sight draft contains only payment instructions and does not include language that relates to the status of the underlying contract. The absence of any such language in the draft or payment demand makes it difficult for the issuer or applicant to point to discrepancies that would justify dishonoring the credit.

 3. The Independence Principle

 The independence principle, or the doctrine of abstraction as it is sometimes called, is perhaps the most fundamental rule of letter of credit law. It requires that the issuer's letter of credit payment obligation (Contract III)
be kept separate from, and independent of, the other contracts or agreements that comprise the overall letter of credit transaction, i.e., the underlying commercial or financial transaction (Contract I) and the reimbursement agreement (Contract II). Thus, if a dispute should arise over whether the creditor had in fact released the debtor from its obligation to repay the $50 million loan, Local Bank must keep its Contract III payment obligation separate from this Contract I dispute and honor its Contract III payment obligation owed the beneficiary as long as a properly worded certificate of default is presented. Even if the creditor had in fact released the debtor from repaying the loan, this Contract I issue would not provide Local Bank with a defense to its Contract III payment obligation. The independence principle would mandate that Local Bank pay the $50 million to the creditor under Contract III. Pursuant to its Contract II obligation, the debtor would then have to reimburse Local Bank for its $50 million payment. Finally, the debtor would have to sue the creditor and prove the release. The independence principle, however, results in the creditor-beneficiary being the stakeholder of the letter of credit funds in the ensuing litigation between the creditor and the debtor over the release and who is entitled to the $50 million under Contract I.

4. The Material Fraud Exception

The independence principle does allow one exception. Absent the presence of a good-faith purchaser, if there is material fraud in either Contract I or Contract II, this material fraud can serve as a defense to the issuer’s Contract III payment obligation. Most issuers, however, will not assert the material fraud defense sua sponte, but will require the letter of credit applicant to seek to enjoin the issuer’s Contract III payment obligation based on material fraud in Contract I. While allegations of material fraud may result in a letter of credit payment being enjoined, courts, at least in the United States, realize that indiscriminately granting such “fraud injunctions” only destroys the

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44 If the creditor had presented Local Bank with a materially fraudulent document, however, Local Bank could have dishonored its Contract III obligation. See U.C.C. § 5-109(a) (2003).

45 Some courts, particularly in Europe, have also recognized illegality as an exception to the independence principle. See Gerald T. McLaughlin, Letters of Credit and Illegal Contracts: The Limits of the Independence Principle, 49 OHIO ST. L.J. 1197 (1989).

46 U.C.C. § 5-109(a)(2) (2003). If it decides to dishonor the draw under the credit, the issuer must do so in good faith. Id.

47 Id. § 5-109(b).
usefulness of the letter of credit payment mechanism. As a result, "fraud injunctions" are rarely granted.

5. Structural Adaptability

The three/four-contract structure of a letter of credit transaction can easily be adapted to help facilitate the resolution of complex disputes.

a. Sharing Issuer Risk

The issuance of a letter of credit shifts the credit risk from the beneficiary to the issuing bank. If the issuing bank is concerned by the amount of its credit risk exposure, the issuer can share the risk with other banks through two risk-sharing arrangements: a syndicated letter of credit or a participation letter of credit.

A syndicated letter of credit is a credit with multiple issuers. As an issuer, each member of the syndicate is liable only for paying the beneficiary its prorata share of the face amount of the credit. In syndication, one bank (the lead bank or agent) generally assumes responsibility for organizing the syndicate and for administering the details of the transaction. For example, the lead bank will usually be specified as the bank to which the documents should be presented. Despite its responsibilities, the lead bank is not liable for paying more than its prorata share of the face amount of the syndicated credit. Organizing a syndicate therefore provides a way for a bank to share credit risk.

A participation credit is a credit in which the lead bank undertakes to pay the full amount of the credit to the beneficiary but sells prorata shares of the credit (participations) to other banks on a non-recourse basis. If the credit is drawn on, the lead bank pays the beneficiary the full amount of the credit and seeks reimbursement from the banks who bought the participations.

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49 Id. (providing that "if a standby with more than one issuer does not state to whom presentation may be made, presentation may be made to any issuer with binding effect on all issuers").
50 See ISP Rule 10.02(b). The sale of participations does not affect the issuer's payment obligation under the standby credit. See the description of a participation credit in In re Enron Corp., 292 B.R. 752, 757-61 (Bankr. S.D.N.Y. 2003).
51 In re Enron Corp., supra note 50, at 760-61.
Although structured differently from a syndicate, a participation credit is another method for an issuer to share credit risk.

A confirmation, however, is not a risk-sharing arrangement like a syndication or a participation. If called upon to pay, the confirming bank must be reimbursed by the issuer for the full amount of the confirmation. Of course, results similar to an issuer syndication/participation can be achieved by creating equivalent contractual arrangements among confirmer. Either of these arrangements, however, while sharing the credit risk among confirmer, would have no risk-sharing effect on the issuer. Partial confirmations where one bank agrees to confirm only part of the issuer’s letter of credit obligation would also have no risk-sharing effect on the issuer. An issuer and confirmer, however, might agree by contract to share the credit risk. Such a contractual relationship, however, would be outside letter of credit law but would presumably be enforceable as a bilateral contract between the two banks.

b. Red Clauses

Letters of credit are normally structured so that payment will be made against the presentation of documents. The basic structure can be altered, however, to permit beneficiaries to receive temporary advances on an unsecured basis from the letter of credit issuer or confirmer without the presentation of documents. Historically such provisions in a letter of credit

52 For example, ISP Rule 11(c)(i) states that unless the context otherwise requires, “issuer” includes “confirmer.” The context of the word “issuer” in Rule 10.01 dealing with syndications does not preclude reading “confirmer” for “issuer.” Therefore just as there can be one credit with more than one issuer so there can be one confirmation with more than one confirmer. If there were to be a syndication of confirmer, however, the issuer would have to request each bank in the syndicate to confirm.

53 U.C.C. § 5-107(a) provides that a confirmer “has the rights and obligations of the issuer to the extent of its confirmation.” The words “to the extent of its confirmation” suggests that a confirmer can limit its confirmation to an amount less than the full amount of the issuer’s original credit. See WUNNICKE ET AL., supra note 5, at 4-19.

54 This agreement between a confirmer and an issuer to share the credit risk might be analogized to a “silent confirmation.” A silent confirmation occurs when the beneficiary requests a local bank to add its “confirmation” to the original credit. The resulting bank obligation is not a true confirmation because not consented to or requested by the issuer. See U.C.C. § 5-102(a)(4) (2003). Although not governed by letter of credit law, the contract between the beneficiary and the local bank would still be enforceable as a bilateral contract outside of Article 5. See U.C.C. § 5-102 cmt. 1 (2003); Dibrell Bros. Int’l S.A. v. Banco Nazionale del Lavoro, 38 F.3d 1571 (11th Cir. 1994).
were typed in red to call attention to them. Red-clause credits developed in the fur trade in Asia. They allowed the seller-beneficiary’s agents to obtain cash advances which they would use to buy the necessary merchandise to ship under the letter of credit. Allowing the beneficiary to utilize some of the value of the letter of credit before shipping documents are procured adds flexibility to the structure of a letter of credit transaction.

c. **Evergreen Clauses**

A letter of credit can include a term that provides for automatic renewal. Thus, a credit can be issued for a term of one year, which term is automatically renewed for another year unless, within a stated number of days prior to the renewal date, the beneficiary draws under the credit or objects to its renewal. Evergreen clauses are helpful in situations where the implementation of a settlement requires ongoing monitoring. The evergreen clause would allow for periodic reassessments in the normal course without one or the other parties questioning the good faith of the other.

d. **Performance Credits**

Standby letters of credit back up payment obligations in a wide variety of transactions. They also back up performance obligations through the use of a liquidated damages clause. For example, the obligor promises to build a house for the obligee by June 30 and agrees to pay the obligee $50,000 in liquidated damages if it fails to complete the house by June 30. The obligee requires the obligor to have Local Bank issue a standby credit securing the payment of the $50,000 liquidated damages amount. If the obligor fails to build the house by June 30, the credit permits the obligee to present Local Bank with a sight draft and a certificate of default certifying that the obligor failed to complete the

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house by June 30.\textsuperscript{57} The obligee should then recover the $50,000 liquidated damages amount.\textsuperscript{58}

e. Reciprocal Credits

In the sale of goods transaction used in this Article, the seller requires the buyer to provide a commercial letter of credit to pay for the wine. The buyer, however, may become concerned that the seller may not ship first-quality wine as required by the contract. No matter how many certificates of inspection are presented as a condition of payment, the seller may still be able to ship substandard wine. If this occurs, the buyer’s normal remedy would be to sue the seller for breach of Contract I. Alternatively, however, the buyer could require that seller have the Bordeaux bank issue a standby credit, obligating itself to pay the buyer if the buyer presents a certificate attesting to the fact that the wine delivered by the seller was not as warranted by the contract.\textsuperscript{59} The effect of this standby credit would be to make the buyer the stakeholder of the $2 million during the ensuing Contract I litigation. The seller would have to file suit against the buyer and, as plaintiff, would bear the burden of proof on the issues. Sellers will normally balk at providing a buyer with a reciprocal standby credit because it reallocates to the seller the risk of buyer dishonesty.

f. Delivery Letters of Credit

Traditionally, a letter of credit issuer undertook an obligation to honor a documentary presentation by the payment of a sum of money. Even when the letter of credit secured the performance of an act by the applicant, the issuer still undertook to pay a specified sum of money upon the beneficiary’s presentation of a certificate attesting to applicant’s failure to perform the act. U.C.C. section 5-102(a)(10), however, permits an issuer to honor a documentary presentation by delivering an “item of value.” While the term “item of

\footnotesize{57} A bank is not a surety company and does not undertake to perform the task if the obligor defaults on its obligation to complete the house by June 30th. See DOLAN, supra note 3, at 1-26 to 27.

\footnotesize{58} Even if the $50,000 payment were adjudged to be a penalty, the independence principle would require that the sum be paid to the obligee. The penal nature of the payment is essentially a Contract I issue that cannot affect the issuer’s Contract III obligation. See McLaughlin, supra note 45.

\footnotesize{59} See KMW Int’l v. Chase Manhattan Bank, 606 F.2d 10 (2d Cir. 1979) (displaying the commercial-standby reciprocal letter of credit structure).
value” is not defined in the U.C.C., the Official Comments state that the term contemplates pieces of paper like stock certificates that represent monetary obligations. UCP Article 3(a), however, defines the undertaking of an issuer more broadly than in U.C.C. Section 5-102(a)(10). Under the UCP, an issuer’s undertaking is to pay “and/or fulfill any other obligation under the Credit.” Therefore, under a UCP credit, the issuer has room to undertake a wider range of performance obligations than simply delivering “items of value” such as stock certificates.

g. Counter-Guarantees

A bank issuer that opens a letter of credit might require the applicant to back up its Contract II reimbursement obligation by having a second bank issue a counter-guarantee in the issuer’s favor. The second bank would obligate itself to pay the first bank if the first bank presented a certificate attesting to the applicant’s failure to make good on its Contract II reimbursement obligation. Letters of credit can be linked together to achieve whatever goals the parties desire.

h. Transferable/Assignable Letters of Credit

The transfer of a letter of credit and an assignment of the proceeds of the credit must be distinguished. A transfer of a letter of credit is essentially a novation: the transferee (second beneficiary) has the right to draw and demand performance under the credit. An assignee of the proceeds, on the other hand, does not have the right to perform but does have the right to receive payment.

Letter of credit law has traditionally prohibited the letter of credit beneficiary from conveying the right to perform under the credit to a third party. In order to permit a transfer of the right to draw under a credit, the credit must be specifically designated as “transferable.” Therefore, the applicant can control whether the credit is issued in transferable or in non-transferable form. By agreeing to the issuance of a transferable credit, the

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60 U.C.C. § 5-102 cmt. 6 (2003).
63 Id. § 5-114 (2003).
64 Id. § 5-112.
applicant loses control over the identity of the person who will perform the Contract I obligation and create and present the required documents. In various contexts, particularly where the buyer relies on the seller's expertise to ship conforming goods, the buyer-applicant for the credit may not wish to permit transfer of the credit.

II. THE BAY OF PIGS AND STANDBY LETTERS OF CREDIT

A. The Dispute

On April 15, 1961, eight aircraft piloted by Cuban émigrés bombed Cuba. Two days later, on April 17, a force of approximately 1,300 Cuban exiles, trained by the United States Central Intelligence Agency at bases in Guatemala, invaded Cuba in the hopes of overthrowing Cuban Premier Fidel Castro. The émigrés landed at a desolate spot on the southern coast of the island called Bahia de Cochinos (the Bay of Pigs). At the last moment, however, the new American President, John F. Kennedy, refused to authorize U.S. air cover for the invasion. Suffice it to say that within four days all the Cuban émigrés in the attack force were either killed or captured by the Cuban army. The calamitous invasion of Cuba was poorly planned and President Kennedy was subjected to widespread criticism at home and abroad for authorizing it.

Humiliated by the Bay of Pigs fiasco, President Kennedy did everything in his power to free the hostages. Early efforts to trade tractors for the prisoners, the so-called Tractors for Freedom plan, unraveled in 1962. Finally, in June 1962, the President's brother, Attorney General Robert F. Kennedy, suggested to members of the Cuban Families Committee, an organization which sought to gain the release of the Bay of Pigs prisoners, that they contact a prominent New York insurance lawyer, James Donovan, to determine whether he would agree to try to convince Fidel Castro to swap the prisoners for supplies. Donovan was recommended to Attorney General Kennedy because of the role he had played in February 1962 in negotiating the exchange of convicted Russian spy Colonel Rudolf Abel for American U2 pilot Gary Powers.

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65 Id. § 5-112 cmt. 2.
67 See James B. Donovan, The Bay of Pigs (entry for June 19, 1962) (private papers of James B. Donovan, Box 40, on file with the Hoover Institute Archives, Stanford University) [hereinafter Hoover Institute Archives].
68 A CIA friend, Michael Miskovsky, recommended Donovan to Robert Kennedy. EVAN
Donovan agreed to represent the Committee. The only restraint Attorney General Kennedy put on Donovan’s negotiating authority was that cash could not be paid to Castro. Throughout the negotiations, the prisoners were held captive in a prison on the Isla des Pins off the south coast of Cuba. There were reports that the captured émigrés were living like animals under extreme conditions.

Before he went to Cuba, Donovan learned all he could about Castro. Among other things, Donovan was struck by Castro’s reputation for irreverence. In their first meeting, Donovan took a risk. When he was introduced to Castro, he inquired puckishly: “Are you ready to defect yet?” The two men immediately liked each other, and despite Castro’s earlier demand for a cash payment of over $2 million for sixty wounded prisoners, he was willing to start anew and consider all options, a prisoners for food/medicine exchange among them. Through the latter half of 1962, a task force of government lawyers and private citizens worked their way through the myriad of problems that a “non-cash” exchange of medicine for prisoners presented. Castro would provide a list of the medicine that he wanted and the government lawyers would try to fill his shopping cart. The value of the commodities ultimately shipped to Cuba totaled $49,300,905 and included items such as pharmaceutical supplies, baby food, and powdered milk.

B. The Use of the Standby Letter of Credit

Before the agreement was finally initialed, Castro insisted on receiving an irrevocable letter of credit guaranteeing the shipment of the goods. Castro’s request led to the drafting of a financial guarantee that is best viewed in three separate components.

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69 JOHNSON, supra note 1, at 312.
70 THOMAS, supra note 68, at 236.
71 Appropriate tax and antitrust rulings were required to elicit contributions of medicine and food from U.S. companies. JOHNSON, supra note 1, at 323-37.
72 News Service Report, The American National Red Cross (June 21, 1963) (on file with the Hoover Institute Archives). A total of 204 manufacturers contributed to the effort. Id.
73 JOHNSON, supra note 1, at 328-29. Letter of credit authority, Henry Harfield, was instrumental in drafting the letter of credit. Id.
1. The Basic Standby Letter of Credit

The basic standby credit was issued in irrevocable form by the Royal Bank of Canada in favor of Banco Nacional de Cuba on December 20, 1962.74

[Image of the Royal Bank of Canada Letter of Credit]

The Royal Bank of Canada
POST OFFICE BOX 1111
MONTRAL, P.Q.

Banco Nacional de Cuba

December 20, 1962

The Royal Bank of Canada

The American National Red Cross has asked us to issue an irrevocable letter of credit in your favor for an amount not exceeding Fifty-Six Million, Nine Hundred and Eighty-Eight Thousand, Two Hundred and Forty-Seven Canadian Dollars (Cdn$56,888,247) available by draft only at sight, payable to the order of Banco Nacional de Cuba.

1. Our agreement will become effective upon delivery to the Canadian Consul at Havana of a completed and authenticated copy of this letter of credit.

2. The amount of this letter of credit shall be reduced from time to time by the amount of invoices inclusive of taxes relating to the foodstuffs and medical supplies referred to in paragraph (1) above.

(1) The letter of credit is republished in this Article, with the permission of the Hoover Institute, infra pages 762-63.

74 See The Royal Bank of Canada Letter of Credit issued on behalf of the American National Red Cross (Dec. 20, 1962) (on file with the Hoover Institute Archives) [hereinafter Royal Bank of Canada Letter of Credit]. This letter of credit is republished in this Article, with the permission of the Hoover Institute, infra pages 762-63.
which invoices the American National Red Cross shall certify to us, on or before July 15, 1963, as having been despatched to you on or before July 15, 1963.

(3) Any draft drawn by you under this Letter of Credit shall be presented for payment not later than July 15, 1963 and shall not be drawn on or presented prior to July 15, 1963 provided, however, that if the American National Red Cross shall certify to us in writing prior to July 9, 1963 that it has been prevented by circumstances beyond its control other than act or omission of the Government of the United States of America from making any contemplated shipment, and is therefore unable to despatch to you the invoices stipulated in (2) above on or before July 15, 1963, we shall on advice you and thereupon, the first date upon which you may draw on or present this Letter of Credit shall be postponed by us for such period as may be required to permit such shipment and despatch to you of the relevant invoices, but under no circumstances shall this postponement be for longer than 6 months from July 15, 1963 and the aforesaid expiry date shall be postponed for a like period not exceeding 6 months.

Yours truly,

[Signature]

E. DARBY

Original signed by

L. W. Lee

[Signature]

HOOVER INSTITUTION

ON WAR, REVOLUTION AND PEACE

[Stamp]
The applicant for the credit was The American National Red Cross. The credit was issued for an amount not exceeding $56,989,247 on Canadian dollars, which at existing exchange rates (U.S. $0.93 per Canadian Dollar) equaled approximately $53,000,000 in American dollars.

The terms of the credit were straightforward. Banco Nacional de Cuba could draw on the Royal Bank of Canada, by sight draft, an amount not exceeding $53,000,000 subject to the following conditions:

a) The Royal Bank’s engagement to pay did not become effective immediately upon opening the credit. The Royal Bank’s credit became effective when the Canadian Consul in Havana received for delivery to the Royal Bank, Banco Nacional’s written statement countersigned by Donovan that Banco Nacional had received advice from the Red Cross that foodstuffs and medical supplies valued at not less than $10,600,000 (twenty percent of the overall promised shipment) had been shipped to Cuba and that the émigrés taken prisoner in the Bay of Pigs invasion had been released from prison and left Cuba.

b) The amount of the Royal Bank’s credit would be reduced “from time to time” by the amount of Red Cross invoices describing shipment to Banco Nacional of foodstuffs and medical supplies with an aggregate stated value not exceeding $53,000,000. The Red Cross could certify these invoices to the Royal Bank up to the close of business in Montreal on July 15, 1963, as having been dispatched to Banco Nacional on or before that date.

c) All drafts drawn by Banco Nacional under the credit were to be presented for payment not later than July 31, 1963, and not prior to July 16, 1963, except under the limited circumstances described in the letter of credit.

2. The Counter-Guarantees

To persuade the Royal Bank to assume the $53,000,000 liability, Bank of America and Morgan Guaranty Trust Company of New York each issued a $26,500,000 counter-guarantee to cover the Royal Bank in the event Banco Nacional drew under the $53,000,000 credit. In lieu of the counter-guarantees, the Royal Bank could have insisted on having the Red Cross’ reimbursement obligation secured by collateral. In the case of a default, however, the Royal Bank would obviously prefer to call on the counter-guarantees rather than to be seen foreclosing on the Red Cross’ assets.

75 JOHNSON, supra note 1, at 329.
3. The Insurance Policy

As the applicant for the issuance of the credit, the Red Cross was liable to the Royal Bank, which issued the credit. Donovan, who represented insurance companies, requested the Continental Insurance Group of New York to underwrite the Red Cross' delivery of the foodstuffs and medical supplies. The insurance policy was written, completing the elaborate series of financial guarantees protecting the Royal Bank.\(^{76}\)

C. Structural Analysis of the Bay of Pigs Credit

The Royal Bank's standby credit was instrumental in convincing Fidel Castro to agree to "the hostages for food/medicine" swap proposed by the United States. A structural analysis of the credit shows its "functionality" in the context of this particular international dispute.

1. Party Willingness to Reach an Agreement

Both sides in the Bay of Pigs dispute wished to resolve it. The Kennedy Administration had been embarrassed by the unsuccessful invasion and was concerned for the well-being of the prisoners on the Isla des Pins. Cuba needed food, particularly baby food and medicine. In addition Castro, a revolutionary at heart, may have secretly admired the Cuban partisans for fighting for that in which they believed. As a consequence, he did not wish to see them languish in prison.\(^{77}\)

2. Neutral Paymaster

Fidel Castro distrusted the United States and, therefore, would not accept a letter of credit issued by a United States bank. The Royal Bank, however, was a neutral paymaster. When there is a dispute between Nation A and Nation B, a bank in Nation C will normally be asked to issue the credit for substantive and cosmetic reasons.

\(^{76}\) Strangely enough, the party with the least enthusiasm for the trade may have been the Royal Bank. It insisted that its Board of Directors approve the issuance of the credit and had no interest in having the credit collateralized by pledged assets. It wanted formal bank counter-guarantees. Id. at 328-29.

\(^{77}\) This was Donovan's perception. Id. at 307.
3. International Issuer

Apart from being a neutral paymaster, The Royal Bank was also a large international entity. The larger and more multinational the institution, the less likely it will engage in any practice that would delay or block payment of one of its letters of credit.

4. Postponed Effectiveness

A letter of credit is enforceable “according to its terms” when the issuer transmits the credit to an adviser or to the beneficiary. The Royal Bank’s letter of credit included a term that postponed its enforceability until the Bank received a written statement from Banco Nacional de Cuba countersigned by Donovan stating that Banco Nacional had been advised that over $10 million of foodstuffs and medical supplies had been shipped to Cuba and that the Bay of Pigs prisoners had been released from prison and had left Cuba. Conditioning the effectiveness of the credit on a condition precedent, in this case the receipt of a statement signed by representatives of both parties certifying mutual performances, was a way of reducing mutual distrust.

5. Undisclosed Principal

The letter of credit structure does not require the real party in interest to apply for the issuance of a letter of credit. In the Bay of Pigs swap, it was the Red Cross which nominally applied for the credit, not the United States government nor any agency of the United States government. Given public sentiment against Fidel Castro, President Kennedy did not wish to be seen formally negotiating with the Cuban Government. The counter-guarantees used to assure speedy reimbursement if the Royal Bank had to honor its letter of credit provided some further distancing for the United States.

78 U.C.C. § 5-106(a) (2003).
79 The Royal Bank of Canada Letter of Credit, supra note 74.
80 JOHNSON, supra note 1, at 325.
III. FACILITATING INTERNATIONAL DISPUTE RESOLUTION WITH STANDBY LETTERS OF CREDIT

A. Resolving Present Disputes

DISPUTE I: CONTROLLING THE SPREAD OF AIDS

Nation A wishes Nation B to take politically unpopular measures such as mandating testing for government employees to contain the spread of AIDS within its borders. Nation A agrees to deliver Nation B $200 million worth of medicine and farming equipment if Nation B takes the necessary measures. Nation B demands iron-clad assurances that, if it takes the unpopular measures, Nation A will not renege on its promise to provide the medicine and equipment.

Nation B can be given the necessary assurances through the issuance of a standby credit similar to the one issued by The Royal Bank in the Bay of Pigs food for prisoner exchange. Nation A requests that Solid Gold Bank, a large international Bank in Nation X, issue a $200 million standby credit in favor of Nation B. The terms of the credit provide that if Nation A fails to deliver the required food and equipment by a specified date, Nation B can present Solid Gold Bank with a certificate of default and a sight draft for up to $200 million. With the $200 million in cash, Nation B can purchase the food and equipment on world markets. Solid Gold Bank agrees to issue the requisite credit, but only if Nation A requests Platinum Bank in Nation Y and Silver Bank in Nation Z to issue their own standby credits in favor of Solid Gold Bank, each securing $100 million of Nation A’s Contract II reimbursement obligation owed Solid Gold Bank. Platinum Bank and Silver Bank agree to issue their respective standby credits.

The combination of the three standby letters of credit will facilitate the resolution of Dispute I by removing the need for Nation B to trust Nation A to perform its part of the agreement. First, if Nation A were to renege on its promise to deliver the medicine and equipment, Solid Gold Bank’s standby credit would permit Nation B to be paid $200 million by presenting a simple certificate of default, the wording of which could be agreed upon in advance. Second, Nation A cannot delay or block payment of Solid Gold Bank’s credit by citing Nation B’s own performance failures under the AIDS agreement as a reason for Solid Gold Bank not to pay the credit. The independence principle of letter of credit law forbids Solid Gold Bank from refusing to honor its Contract III payment obligations based on alleged breaches of the Contract
I agreement between Nation A and Nation B. Third, Solid Gold Bank will not act on its own to delay paying its credit. Solid Gold Bank is adequately secured if it has to make its $200 million payment. Nation A as applicant and Platinum Bank and Silver Bank as letter of credit counter-guarantors are all obligated to reimburse Solid Gold Bank.

Two additional points might be considered in the analysis of Dispute I.

First, if Solid Gold Bank were concerned by its $200 million exposure in issuing the standby credit, it could decide to issue either a syndication credit or a participation credit. By involving a group of banks in issuing the credit, Solid Gold Bank can spread credit and political risk.

Second, U.C.C. Section 5-102(a)(10) permits a letter of credit issuer to honor a documentary presentation by delivering an item of value. Obviously food and medicines were not envisioned as items of value within the meaning of the U.C.C. section. Less clear, however, is the meaning of UCP Article 3(a) which speaks of the bank's undertaking "to fulfill any other obligation under the Credit." A broad reading of these words would blur the classic divide between a bank and a surety company. On its surface, UCP Article 3(a) would permit a letter of credit bank to agree to deliver to Nation B $200 million of food and medicine if Nation B presented a certificate of default. A more prudent reading of these words would limit the obligations referred to as financial obligations similar to the payment obligations already listed in the UCP Article.

DISPUTE II: LIMITING WEAPONS OF MASS DESTRUCTION

Nation A and Nation B are signatories to a treaty banning the production of biological weapons. Nation B begins producing a biological fertilizer that arguably has applications as a weapon. Nation A offers Nation B $100 million in farm equipment and other machinery if Nation B ceases producing the biological fertilizer. Neither Nation will perform its part of the agreement until it has definite assurances that the other Nation has in fact begun its performance.

A standby letter of credit that requires the presentation of two certificates, a certificate of inspection and a certificate of default, can facilitate the resolution of Dispute II. Nation A requests Solid Gold Bank to open a $100 million standby credit, conditioning payment upon Nation B's presentation of

81 See supra notes 48-51 and accompanying text.
82 See DOLAN, supra note 3, at 1-27.
a certificate of default stating that Nation A has failed to deliver the promised medicine and equipment by the specified date. Solid Gold Bank, however, issues the credit subject to a condition precedent as to its effectiveness: Solid Gold Bank’s obligation to honor Nation B’s draw becomes effective only after Nation B presents the Bank with a certificate signed by John Jones, a biologist from Nation X, attesting to the fact that Nation B has begun to dismantle its fertilizer production facility.

Here, Solid Gold Bank’s standby letter of credit links the performances of Nation A and Nation B. Nation A need not be concerned that Nation B might fraudulently draw on the credit before starting to dismantle its production facilities. Nation B cannot be paid under the credit until John Jones certifies that Nation B has begun its dismantling. If Nation A were concerned that Nation B might bribe John Jones to falsify the certificate of inspection, Nation A could require additional signatures on the certificate. Similarly, Nation B need not be concerned that Nation A will fail to deliver the medicine and equipment even though Nation B starts dismantling its fertilizer production facility. Once John Jones’ certificate of inspection is presented to Solid Gold Bank by Nation B, the letter of credit becomes effective.

A less satisfactory linkage of United States—Cuba performances occurred in the Bay of Pigs letter of credit. The effectiveness of the Royal Bank’s obligation to pay $53 million was conditioned upon receipt by the Royal Bank of a written statement signed by representatives of both parties, certifying that shipments of medicine and food had been sent to Cuba and that the prisoners had left Cuba.3 Certificates issued by independent inspectors would have been preferable to certificates issued by agents of the parties to the transaction. Certifications from independent inspectors, as opposed to agents of the parties, remove the possibility of bias and/or self-interest from the process.

B. Avoiding Future Disputes—Integrity Pacts

Integrity pacts are defined in this Article as agreements among nations either to perform or not to perform a future act. Dispute III involves an integrity pact to perform an act (participating in the next Olympic Games). Dispute IV involves an integrity pact not to perform an act (fishing for whales).

3 See The Royal Bank of Canada Letter of Credit, supra note 74.
DISPUTE III: PARTICIPATING IN THE OLYMPIC GAMES

Stung by recent political boycotts, the International Olympics Committee (IOC) wishes to keep participation in the next Summer Olympic Games "non-political." The IOC asks each nation wishing to participate in the next Games to open a standby letter of credit in favor of the IOC within thirty days after the close of the prior Games. The IOC requests these credits be issued by a bank chosen from a pre-approved list of international banking institutions. The amount of each credit is determined by the IOC based on the number of a nation's athletes who competed in the prior Games. Nation A requests Solid Gold Bank, a bank on the approved list, to open a standby credit for $15 million, the amount set by the IOC.

In Dispute III, the issuance of the standby credit will not prevent Nation A from deciding to boycott the next Olympic Games but it will present a political obstacle to the decision. If Nation A boycotts, the IOC will draw on the credit. Since the IOC's draw is not materially fraudulent, Solid Gold Bank will honor the draw and demand reimbursement from Nation A. The government of Nation A will then have to explain to its people why its decision four years ago to "de-politicize" participation in the Olympic Games by agreeing to issue the credit is no longer national policy.

DISPUTE IV: PROHIBITING WHALING

In recent years, the population of whales has substantially decreased worldwide. The International Whaling Commission (IWC) asks its member nations to impose a ban on whaling. There is evidence that some member nations have continued whaling despite the ban. The IWC, however, does not have the financial resources to police compliance with the ban.

To facilitate the resolution of Dispute IV, the IWC asks Nation A and each other member nation to post a $10 million standby letter of credit in favor of the IWC. Solid Gold Bank issues the required credit on Nation A's behalf, obligating the Bank to pay the IWC $10 million if the IWC presents the Bank with a certificate attesting to the fact that Nation A has continued whaling despite the ban.

In Dispute IV, the standby credit will pose a financial and legal deterrent to Nation A's continued whaling. Once the IWC presents the requisite certificate and draws on the credit, Nation A cannot prevent Solid Gold Bank from paying the credit unless Nation A can prove the IWC had filed a fraudulent certificate. Therefore, if it wishes to challenge the accuracy of the
allegations made in the IWC’s certificate, Nation A will have to sue the IWC to recover the $10 million. As the plaintiff, Nation A will have the burden of proving to the court that it was wrongly accused by the IWC. Payment of Nation A’s letter of credit therefore switches the burden of proof on the relevant issues from the IWC to Nation A. Assuming the IWC prevails in the lawsuit, the proceeds from the draw on Nation A’s credit will be used to strengthen the activities of the IWC.

C. Avoiding Future Disputes with “Frankpledge” Credits

DISPUTE V: Enforcing United Nations Assessments

The United Nations Security Council asks member nations to contribute $5 million each to a special fund to be used to send peace keeping forces into Nation W. Ten nations pledge contributions. To guarantee that these nations will not renge on their financial commitments to the special fund, the UN requests the ten nations to apply jointly to Solid Gold Bank to issue a standby letter of credit for $50 million, the sum total of the contributions promised by the ten nations. The terms of the credit allow the UN Secretary General to draw on Solid Gold Bank for the full $50 million if any one of the ten nations refuses to pay its contribution. The reimbursement agreement between Solid Gold Bank and the ten nations obligates each nation to pay Solid Gold Bank its own one-tenth share of the reimbursement ($5 million) plus a proportionate share of the reimbursement of any defaulting nation. After the credit is issued, Nation A decides not to make its promised contribution. The Secretary General draws on the credit by presenting Solid Gold Bank with a certificate attesting to the refusal of Nation A to contribute to the special fund.

The structure of this letter of credit is a form of modern-day frankpledge. During the Middle Ages, the frankpledge was “a police system under which each man was a pledge for the good behavior of every other man in his tithing, which was a group of originally ten men.” The members of the tith, therefore, were responsible financially for the acts of their fellow tith members. If a member of a tith killed a cow, his fellow tith members had either to produce the felon to pay the appropriate fine for killing the cow or pay the fine among themselves.

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64 McLaughlin, supra note 45, at 11.
65 JOHN HAMILTON BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 13 (1974).
The frankpledge model of group responsibility for paying damages suggests an innovative model for using standby credits to secure nations' compliance with integrity pacts. In the case of a draw, a frankpledge credit would obligate each nation applicant by contract to pay not only its own share of the Contract II reimbursement obligation but also a proportionate amount of defaulting members' shares. Because the other nations in the group have to pay more because Nation A refuses/fails to make its promised contribution to the UN fund, Nation A will be subjected to political pressure from the other nine nation-applicants for the credit. Not wishing to see the standby letter of credit called by the Secretary General, the other nine nations will try to persuade Nation A to make its promised contribution. The structure of the frankpledge credit necessarily brings political and financial pressure to bear on any applicant such as Nation A considering whether to default on its commitment.

IV. HUMANITARIAN LETTERS OF CREDIT AND THE IRAQI OIL FOR FOOD PROGRAM

A. The Dispute

Iraq invaded Kuwait on August 2, 1990.\textsuperscript{86} Four days later on August 6, 1990, pursuant to Resolution 661, the UN Security Council imposed comprehensive economic sanctions on Iraq.\textsuperscript{87} In April 1995 the Security Council adopted Resolution 986 as a temporary measure, allowing Iraq to export a certain quantity of oil on a controlled basis and using the revenues from these sales of exported oil to buy humanitarian supplies. The Iraqi Government agreed to Resolution 986 in May 1996.\textsuperscript{88} Under the Resolution, Iraq was permitted to sell $2 billion worth of oil during every six-month period. Thirty percent of the revenues from these sales of oil was allocated to the Compensation Fund to pay off war reparations from the 1990-91 Gulf War. Another four percent was allocated to cover the expenses of UN agencies working in Iraq. The final sixty-six percent was earmarked for the purchase of food, medicine, and other humanitarian supplies for the Iraqi people.\textsuperscript{89} From the beginning,

\textsuperscript{88} See \textit{Anglican Observer Office at the U.N., Iraq Sanctions: Humanitarian Implications and Options for the Future} 21 (2002).
\textsuperscript{89} Id.
commercial letters of credit have played an important role in these purchases.\textsuperscript{90} Although something of a misnomer, these commercial credits have been dubbed "humanitarian credits."

B. The Use of Commercial Letters of Credit

The use of commercial letters of credit in the context of the Iraqi oil for food program is illustrated by the following transaction.\textsuperscript{91}

When the UN embargo was lifted to allow sales of a quantity of Iraqi oil, the proceeds of those sales were deposited into an escrow account controlled by the UN Treasury Office called the United Nations Iraq Account. This escrow account provided the source of funds used to pay for humanitarian aid imported into Iraq.

A non-Iraqi seller of food or medicine and an Iraqi buyer enter into a contract whereby the Iraqi buyer agrees to import specified goods into Iraq. To pay for the goods, the Iraqi buyer (the applicant) requests the Central Bank of Iraq to open an irrevocable, non-transferable and non-assignable letter of credit in favor of the seller.\textsuperscript{92} Assuming it approves the sale, the Central Bank forwards the request to open the letter of credit in the required form to the New York Office of Banque National de Paris (BNP), the Bank selected to issue the credits. To assure that it will be reimbursed for any payments made under the credit, BNP faxes a request to the UN Treasury to approve the issuance of the credit and the payment of its fees. If the UN Treasury approves the issuance of the credit, it will segregate an amount of money out of the United Nations Iraq Account to cover the amount of BNP's credit and related fees. Protected by the cash collateral in the United Nations Iraq Account, BNP proceeds to open the credit in favor of the non-Iraqi seller.

UN regulations provide that any credit opened by BNP as part of this Oil for Food Program must state that the credit is issued pursuant to certain named United Nations documents. The credit must also state that it is issued subject to the 1993 Revision of the UCP\textsuperscript{93} and under BNP license No. 10-758 of the U.S. Department of Treasury's Office of Foreign Asset Control.

\textsuperscript{90} The Oil for Food Program was terminated by the Security Council in UN Security Council Resolution 1483 (May 22, 2003).
\textsuperscript{91} See UN Office of the Iraq Programme, 4-6 (Apr. 8, 2003) [hereinafter Iraq Programme].
\textsuperscript{92} Id. at 1.
\textsuperscript{93} The credits were commercial letters of credit and therefore were appropriately made subject to the UCP instead of the ISP, which apply to standby credits.
Once the credit is opened, the seller ships the humanitarian supplies to Iraq where they are inspected by independent agents appointed by the UN Secretary General. If the goods are found to be conforming, BNP is notified by the UN. Seller now presents BNP with the shipping documents required by the letter of credit.

If BNP finds that the documents strictly comply with the terms of the credit, BNP purchases the documents from the seller and is reimbursed out of the United Nations Iraq Account. If, however, BNP examines the documents and discovers discrepancies, it must either notify the seller-beneficiary of the discrepancies so the seller-beneficiary can effect cure by re-presenting conforming documents or go back to the buyer-applicant through the Central Bank of Iraq to determine whether the buyer-applicant will waive the discrepancies and allow reimbursement out of the escrow account. If the discrepancies are neither waived nor cured, BNP will rightfully dishonor the credit.

C. Structural Analysis of the Credit

1. Non-Transferable Nature of the Credit

As noted above, whether a letter of credit is issued in transferable or non-transferable form is controlled by the applicant. The ability to limit the draw to the named beneficiary is particularly important to a buyer in a sale of goods transaction. The buyer may trust the named seller-beneficiary to ship the requisite goods but may not have the same level of trust in a different seller.

Considerations other than buyer protection also dictated the use of non-transferable credits in the Oil for Food Program. Both the Central Bank of Iraq and the UN approved each sale. Once a transaction had received the necessary approvals, it made little sense to allow the original seller to bring a new seller into the transaction, leading to the need for another round of approvals.

2. Non-assignable Nature of the Credit

While the right to transfer commercial letters of credit is restricted to credits specifically marked as transferable, the proceeds of a commercial letter of credit are freely assignable by the beneficiary. Pursuant to U.C.C.

95 See id. § 5-114(b). The assignability of letter of credit proceeds can be limited by
Sections 1-102 (3) and (4), however, the beneficiary and the issuer can agree that the proceeds of the credit are not assignable. Similarly, the issuer of the credit, however, can refuse to recognize assignments by the beneficiary. Credits issued under the Iraqi Oil for Food Program must be marked as "non-assignable," except that the beneficiary can assign the proceeds of the credit to the beneficiary's supplier for financing the purchase of the humanitarian goods. Denying the assignability of the proceeds to all those except a party financing the sale transaction keeps the proceeds of the credit with its humanitarian purposes from becoming a part of extraneous issues relating to third parties.

D. Use of Multiple Certificates

To trigger payment of a humanitarian letter of credit under the Iraq Oil for Food Program, the seller-beneficiary must present, in addition to the required commercial documentation, various certificates or approvals idiosyncratic to the nature of the transaction. For example, the seller-beneficiary must present a letter from the Committee saying that the seller-beneficiary has been pre-cleared for payment out of the United Nations Iraq Account. The seller-beneficiary must also present a document confirming that seller-beneficiary's goods have arrived in Iraq. Although the independence principle of letter of credit law prevents BNP from looking behind these statements to determine their factual accuracy, merely requiring that the seller-beneficiary provide the written certificates serves a policing function.

V. FACILITATING INTERNATIONAL DISPUTE RESOLUTION WITH COMMERCIAL LETTERS OF CREDIT

DISPUTE VI: DIRECTING EMERGENCY/FOREIGN AID

Because of famine, Nation A pledges $25 million in emergency aid to Nation B. Nation A, however, wishes the $25 million in emergency aid to be spent solely on food purchases from farmers in Nation A. Nation B objects to agreement. *Id.* § 1-102(3), (4). *Cf. id.* § 9-409(b).

96 "An issuer ... need not recognize an assignment of proceeds of a letter of credit unless it consents to the assignment." *Id.* § 5-114(c); *see also id.* § 9-409(b).

the restriction, claiming that it can buy food cheaper in Nation X than in Nation A.

A resolution of Dispute VI can be achieved by a innovative use of a certificate of approval executed by Nation A. Nation B applies to Solid Gold Bank to open commercial letters of credit to pay for food purchases. Solid Gold Bank agrees to honor its payment obligations if it receives the normal shipping documents from the farmers who are selling food to Nation B. As a further condition of payment, however, Solid Gold Bank must receive a certificate from Nation A stating either that the particular farmer is a citizen of Nation A or if the farmer is not a citizen of Nation A, the price of the food sold by the farmer is below the price of comparable food sold in Nation A as measured by an international survey of food prices.

These commercial credits satisfy Nation B's desire to purchase food at the lowest prices and satisfy Nation A's desire to support its own farmers. The terms of the certificates could be drafted even more intricately. For example, through the use of certificates, low cost food sales could be limited to no more than thirty percent of the $25 million in emergency aid. If Nation B approved, Solid Gold Bank might insert a red clause in its credits, allowing the farmer beneficiaries to draw on the credits in advance of shipping the goods.

VI. CONCLUSION

The Secretary of State or Foreign Minister of a nation rarely, if ever, travels with a banker. This Article suggests that this policy should be reexamined. As demonstrated by the Bay of Pigs crisis and the Iraqi Oil for Food Program, banking instruments can be helpful in facilitating the resolution of certain international disputes. The word "facilitate" is used in this Article in both a legal and a psychological sense. Once nations agree to settle a dispute, the rules of letter of credit law can act to reduce subsequent disagreements over implementing that settlement. In addition, knowing that letters of credit can neutrally implement the terms of a settlement also has a positive effect on the process of negotiating that settlement. A nation concerned about another nation's trustworthiness may be more willing to agree to a settlement once they understand how letters of credit can remove trust from the implementation phase of an agreement. Implementation becomes an issue of the wording of bank certificates and documents.

Obviously, a letter of credit is not a panacea. For the special rules of letters of credit to work, nations must be willing to reach a settlement or at least be willing to explore reaching a settlement. But once there is the willingness,
bankers can fashion letters of credit singly or in combination to help turn that willingness into a reality.

Using bank payment obligations to help resolve international disputes will have its detractors. Political disputes among nations are inherently different from private disputes among individuals. Banks themselves may become concerned about their involvement in volatile political situations. History has taught banks that it can be dangerous to become involved in counseling governments.98 Still as banks grow larger and more sophisticated, techniques applied to finance may apply equally well to politics.

98 King Philip IV of France became jealous of the Knights Templare (the bankers of the twelfth and thirteenth centuries) because of their wealth and prestige. See Weathorford, The History of Money: From Sandstone to Cyberspace 64-71 (1997).