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Standby Letters of Credit and Other Bank Guaranties: Revisited

Timothy D. Naegele*

In 1975, Congress considered measures to regulate the issuance of standby letters of credit and other bank guaranties, which presented inordinate risks to America's economic system, and to the safety and soundness of U.S. financial institutions. In the ensuing years, the use of these financial instruments has grown exponentially, and the risks have become even more acute, certainly in times of financial stress and crises. In this article, the proponent of the proposed legislation discusses these issues and more, and provides a sense of what might be expected in the years to come as this area of economic activity and regulation continues to evolve. In the final analysis, he asks and answers the questions: has anything reduced the risks to banks and other financial institutions, and to our economic fabric as a whole, resulting from the unbridled issuance of such commercial instruments? Also, can our financial system withstand a panic that involves massive defaults on the underlying obligations—which have given rise to such guaranties—and that produces runs on such guaranties and simultaneous demands for immediate and economy-crushing payments? Will Congress, the Federal Reserve and other central banks be helpless if this

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See, e.g., Timothy D. Naegele, *The Anti-Tying Provision: Its Potential Is Still There*, 100 Banking L. J. 138 (1983) (Naegele 1983) (http://www.naegele.com/articles/antitying.pdf); Timothy D. Naegele, *The Bank Holding Company Act's Anti-Tying Provision: 35 Years Later*, 122 Banking L. J. 195 (Naegele 2005) (http://www.naegele.com/documents/antitying_3.pdf); Timothy D. Naegele, *The Bank Holding Company Act's Anti-Tying Provision: Almost 50 Years Later—Part I*, 135 Banking L. J. 315 (June 2018) (Naegele 2018, Part I); Timothy D. Naegele, *The Bank Holding Company Act's Anti-Tying Provision: Almost 50 Years Later—Part II*, 135 Banking L. J. 372 (July/August 2018) (Naegele 2018, Part II) [The combined article, Parts I and II, can be read at https://naegeleblog.files.wordpress.com/2018/08/timothy-d-naegele-banking-law-journal.pdf]. *See also* Timothy D. Naegele, *Are All Bank Tie-Ins Illegal?* 154 Bankers Magazine 46 (1971) (Naegele 1971) (http://www.naegele.com/articles/banktieins.pdf); and Timothy D. Naegele, *Fed Plan Would Simply Gut Enforcement Of Ban on Tying,* American Banker (January 21, 2005) [*see* https://naegeleblog.files.wordpress.com/2018/08/op-1158_56_1.pdf (letter sent by Timothy D. Naegele to each member of the Federal Reserve Board ("Fed") (March 16, 2005), and the American Banker article)].

happens; and will the domestic and global economies implode?

The United States has experienced periods of boom and bust since its rich history began. Such is the basic nature of economic cycles, and of our capitalist system that influences—if not governs—global economic activity. Like the laws of gravity, certainties exist in economics too. What goes up, comes down; sometimes with a resounding thud.

When crises arise, as they will, public policymakers in the United States and other countries must be prepared to deal with them in a responsible and effective manner, and have tools at their disposal to do so. One area of economic activity that few Americans know about, much less comprehend, involves the staggering amounts and extensive uses of guaranties—issued globally by banks, other financial institutions, businesses and governmental agencies.[1]

This article deals with that subject, and in particular with standby letters of credit and other bank guaranties, and with their counterparts in other areas of domestic and international commerce. It builds on an earlier discussion and debate of such issues before the U.S. Senate more than 40 years ago, between the author and the late Henry Harfield.[2]

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[1] For example, in a lawsuit where a judgment of more than $4 million was rendered against a bank—based in part on violations of the anti-tying provision—the bank's federal regulator was permitted to issue a letter of credit (or guaranty) on behalf of the bank, which allowed it to appeal the verdict.

See Naegele 2018, Part I, *supra*, 336–338 (discussing *Lucken et al. v. Heritage Bank National Association et al.*, U.S. District Court for the Northern District of Iowa, Case # 5:16-cv-04005, PACER Docket Sheet entry 197, paragraphs 6-8 ["Pursuant to Federal Rule of Civil Procedure 62(d), if an appeal is taken, the appellant may obtain a stay by supersedeas bond. . . . Defendants have obtained . . . a Letter of Credit in favor of Plaintiffs for an aggregate amount not to exceed $5,000,000.00, available through Federal Home Loan Bank of Des Moines, Des Moines, Iowa. . . . In addition, Plaintiffs and Defendants have executed an agreement setting forth the events of default which would trigger calling upon the letter of credit"]).

[2] *See* Timothy D. Naegele, *Standby Letters of Credit And Other Bank Guaranties*, Compendium Of Major Issues In Bank Regulation, Committee On Banking, Housing And Urban Affairs, United States Senate 621 (May 1975) [https://naegeleblog.files.wordpress.com/2018/08/naegele-standby-letters-of-credit-and-other-bank-guaranties.pdf] (Naegele 1975); *see also id.* at 689-706 (*citing* CONG. REC., 93d Cong., 2d Sess. (August 22, 1974)), with respect to S. 3949 ("A BILL . . . To regulate liabilities insured by certain banks in connection with guaranties, surety agreements, certain bank acceptances, and standby letters of credit"); Melvin R. Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L. J. 697, 704-710, 713-714 (1975) (""[T]he battle being waged by the experts may be characterized as one between commercial progressives and financial conservatives. On the one side stands Henry Harfield, on the other Timothy D. Naegele, both eminent spokesmen for their respective

(Text continued on page 202)

positions. . . . Naegele . . . concludes that standby letters are, indeed, illegal guaranties, not incidental to any express powers granted national banks, and that the issuance of guaranties are acts prohibited to national banks absent a "substantial interest" in the transaction. Mr. Harfield concedes the need for regulation since he feels that such credits are a legitimate feature of a national bank's powers. On the other hand, Mr. Naegele is of the opinion that regulation is not in order until there is a definitive statement as to whether standby letters are illegal *vel non*. . . . Both Mr. Harfield and Mr. Naegele achieve a consensus, of sorts, on the question of imposing lending-limit restrictions. Mr. Harfield's analysis is that standby letters of credit are the functional equivalent of loans and should be assessed against a given customer's lending limits. Likewise, Mr. Harfield advocates that examiners classify and criticize credits in the same manner as loans. . . . A larger question that Mr. Harfield does not face is dealt with by Mr. Naegele. He too would have standby letters treated as loans for limitation of liabilities of a national bank and for examination purposes. However, Mr. Naegele would proceed even further and require aggregation of lending limits by looking through to the ultimate user of the credit. Under this theory, obligation[s] of a corporation would include all obligations of all subsidiaries. On the question of examination, Mr. Naegele strenuously objects to footnoting of standby credits on bank balance sheets. Nothing short of full balance sheet disclosure would satisfy him. Naegele urges that "if standby letters of credit are to be treated as loans, a bank 'should apply the same credit evaluation techniques when issuing a letter of credit that it would apply when making a loan in an equivalent amount to its customer.' . . ." He points out that "any such credit evaluation should take into account the realities of the transaction, such as the likelihood that the user will continue to make payments under the 'lease,' the likelihood that the commercial paper-standby letter of credit obligations can be rolled over in the commercial paper market, and the likelihood that the user will be solvent and liquid enough to stand behind its 'indemnity' or other protection to the bank." Mr. Naegele concludes: "If the aggregate liabilities limitation and lending limit are to apply to standby letters of credit, these obligations 'should be adequately reflected on a bank's published financial statements.' . . . This would mean that the appropriate entries should not merely appear in the footnotes, or as a 'memorandum item' to the bank's report of condition, but in the main body of the report. In this connection, it should be noted that the Comptroller of the Currency has ruled that secondary liabilities, such as arise on the indorsement of notes sold by the bank for its own account 'should be reflected as a liability on the records and in the reports of condition of the bank. . . .' . . . "Final regulations of the three banking agencies should clarify the balance-sheet treatment of standby letters of credit. At present, the Comptroller proposes to require that a national bank's balance sheet contain merely 'a footnote showing the total amount of standby letters of credit outstanding.' . . ." . . . In considering the aggregation or combining of lending-limits liabilities, Mr. Naegele stresses the importance of identification of the true borrower. In the dummy corporation example, wherein the dummy is created to finance the purchase and lease of property, he quite properly observes that the bank, as in all loan transactions, should undertake a full credit analysis. Obviously, in that context, the bank is not looking to the character, collateral, or capacity of the dummy to repay, but rather of the user, who is making the lease payments. Indeed, the Comptroller has adopted precisely that stance with regard to loans to industrial development authorities. . . . One last area remains to be tested in this analytical crucible, and centers around the issue of imposition of reserve requirements. Mr. Harfield's notion of the policy of marginal reserve requirements is that they are an assurance of availability of funds to meet bank obligations and a means of implementing monetary policy. In their normal use marginal reserves are set up

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against bank liabilities or deposits. Mr. Harfield states that since standby credits are assets or loans, there is no safety factor akin to the protection of depositors to be protected. And, with regard to monetary policy considerations, he also declares that a reserve requirement would only serve to increase the cost of standby letters but would have no offsetting benefits to the bank. In direct contradistinction, Mr. Naegele discerns reasons for imposition of marginal reserve requirements. His rationale appeals to the analogy of current Federal Reserve regulations on issuance of commercial paper by banks both as a means of obtaining funds, and as a tool of monetary policy to control the inflation. Mr. Naegele notes that the Federal Reserve's Regulation D currently treats commercial paper obligations of banks as a method of obtaining funds for use in its banking business as "deposits" and thereby, subject to reserve requirements. In the standby credit arrangement involving issuance of commercial paper, the bank obtains funds from the commercial paper to lend to a specific customer while its other available funds remain constant. Due to the fact that the effect is the same—funds are being obtained by the bank for lending purposes—Naegele argues that reserve requirements are necessary. In addition, he points out that a standby credit constitutes a loan of that credit as opposed to funds derived from deposits. The effect, however, is the same. Monetary policy, according to Mr. Naegele, requires marginal reserves to control the inflationary ramifications of standby credit. . . . The net effect of the Brooke Bill would be to incorporate the bulk of Naegele's suggestions. A necessary concomitant would be the effect on a bank's credit analysis and balance sheet disclosure, the latter being of particular aid in the examination process. A comparison of what the Comptroller has done in contrast to the Brooke proposals draws into sharp relief the fundamental difference in philosophy. Brooke's Bill, by way of exemplification, offers no exceptions to lending-limit restrictions as do the Comptroller's rules. So too, the Brooke proposal provides for mandatory reserves in as much as standby letters are treated as deposits. In the aftermath of the demise of the United States National Bank of San Diego, due in part to unregulated and unwise use of standby letters of credit and to the impact of the current inflation, that besieges the nation, Naegele's and Brooke's logical analysis is given even more puissance. . . . There would seem to be a compelling need for requiring full credit analysis in the interest of sound banking practice. The balance sheet disclosure aspects of the Brooke Bill also tie in neatly with recent SEC efforts to achieve the liquidity disclosure of financial institutions"") (footnotes omitted); Henry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits*, 3 Colum. Bus. L. Rev. 705, 720–721, 722, 724 (1988) (""The most outspoken legislative critic of standby letters of credit when their issuance escalated sharply in the 1970's was Senator Edward W. Brooke, a Republican from Massachusetts. He introduced a bill which would have regulated standbys in the following ways: a national bank's potential liability on standby letters of credit, bank acceptances, guaranties, and surety agreements would be limited to the legal limitation on total liabilities of a national bank (100% of its capital stock and 50% of its surplus); the customer's potential obligation to the bank under the standby would have been counted toward the legal limitation on loans to one borrower, with certain minor exceptions; all member banks of the Federal Reserve System would be required to meet reserve requirements on standby and other contingent obligations; state member banks would be under the same legal limitation on total liabilities that would apply in the case of a national bank, and the same limitation on loans to one borrower. . . . Senator Brooke attached an opinion prepared by another letter of credit expert, Timothy D. Naegele, which supported Senator Brooke's allegations and recommendations. The opinion characterized the views of [Henry] Harfield as "an effort to state what national banks should be able to do in the area of 'standby' letters of credit, rather than what they are lawfully

The author's Senate submission and its attachments[3] constitute a useful starting point for the discussion of this subject; and they will be referred to and quoted in this article. The author respectfully suggests that it might be useful for the reader to review them. Also, unlike other law review/journal articles that have addressed the nuances and technicalities of standby letters of credit—often in minute detail[4] —this article concentrates on the safety and soundness of standby letters of credit and other guaranties, and their potential adverse effects on the American and global economies, especially in the midst of an ever-accelerating financial crisis of the future.

Since 1975, crises have come and gone; and the issue today is what public policymakers have learned in the interim about how to anticipate and address them. As noted previously:

> Guaranties have been used in commercial transactions for centuries, in various contexts and in various parts of the world. Banks have not been alone in their willingness to engage in such undertakings, and have sought new methods of characterizing guaranty transactions in recent years, in an effort to circumvent legal bars as to these practices.
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> A guaranty is a promise by one party to answer for the payment of some debt, or the performance of some obligation, in case of the default of another party, who is in the first instance liable for such payment or performance.[5] A standby letter of credit is merely one form

permitted to do." . . . Unfortunately, the courts have not been as insightful as Senator Brooke in their analysis of standby letters of credit. Most courts routinely and without significant analysis uphold beneficiaries' right to payment under standby letters in all but the most blatant cases of fraud."") (footnotes omitted).

[3] *See supra* n.2 and Naegele 1975.

[4] *See, e.g.*, *infra* n.14.

[5] *See* Gerald T. McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 Ohio State L. J. 1197, 1235 (1989) ("According to the independence principle, irrevocable letters of credit—whether commercial or standby letters of credit—must be kept separate from, and independent of, the other contracts and agreements which generated them. . . . Serious fraud in the underlying transaction is a recognized exception to the independence principle"); Christopher Leon, *Letters of Credit: a Primer*, 45 Md. L. Rev. 432, 435 (1986) ("In addition, the issuer may share the risk of a particular transaction through a participation agreement with another institution, a back-up letter of credit, or a multibank credit") (*citing* Reade H. Ryan, Jr., *Letters of Credit Supporting Debt for Borrowed Money: The Standby as Backup*, 100 BANKING L. J. 404, 416-21 (1983)); Leon, *supra*, 436 ("*In re* Twist Cap, Inc., 1 Bankr. 284 (Bankr. D. Fla. 1979) (bankruptcy court enjoined bank from honoring standby letters of credit because the payment would constitute an impermissible [sic] preference).

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In re Twist Cap has been criticized by several commentators. *See, e.g.,* Comment, *The Standby Letter of Credit: What It Is and How to Use It,* 45 Mont. L. Rev. 71 (1984) (when a bank customer files a bankruptcy petition, payment by the issuer of a letter of credit should not be enjoined as a preference because the credit is not an executory contract subject to rejection by the bankruptcy trustee, the debtor is not a party to the letter of credit or obligated thereunder, and the issuer pays the beneficiary with its own funds, not with the assets of the customer)") (*see also* Douglas G. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. Chi. L. Rev. 130, 131-132, 153-154 (1982) (discussion of *Twist Cap*)); Leon, *supra*, 442-443 ("Letters of credit are also used in situations where one party seeks to protect itself from another party's unsatisfactory performance or inability to perform. In this role, the letter of credit is referred to as a 'guarantee' or 'standby' letter of credit and is payable in the same manner as a commercial letter of credit, upon presentation of a draft or other specified documents") (footnote omitted); Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. Chi. L. Rev. 218, 219–220, 222 (1985) ("Increasingly, American companies have used a variation of the letter of credit, known as the 'standby' letter of credit, in both domestic and international commercial transactions. The standby letter of credit differs from the traditional letter of credit in that the beneficiary may draw on the standby letter of credit only after the customer defaults on the underlying contract. For example, in connection with the sale of goods or services, the purchaser might require the seller or provider of the services to obtain a standby letter of credit in the purchaser's favor. The condition for payment under the letter of credit would be the presentment to the issuing bank of a draft and a written statement that the seller had failed to perform (or had performed inadequately). The amount of money payable under the letter of credit would be a percentage of the contract price, and payment under the standby letter of credit would serve as immediate compensation to the purchaser for any damages he may have suffered from the other party's nonperformance. This form of letter of credit has been frequently used in contracts between Western suppliers of goods and services and Middle Eastern purchasers. . . . Standby letters of credit and traditional letters of credit are both mechanisms for allocating risks among the parties in commercial transactions. By placing in the hands of a neutral third party the responsibility for making payment when certain conditions are met, one party to a transaction is able to avoid the risk of nonpayment or nonperformance. The standby letter of credit differs from the traditional letter of credit, however, in the method by which it allocates the risks among the parties. The traditional letter of credit usually requires a third party to generate some of the documents that the beneficiary must present to the issuer (usually a bill of lading); under the standby letter of credit, the beneficiary usually generates all of the necessary documents himself (usually a simple statement that the customer is in default). The standby letter of credit thus involves a greater risk of improper demand than the traditional letter of credit, both for the customer and for the issuing bank. Because the independence rule prohibits the bank from inquiring into the truth of the beneficiary's assertion, the customer faces a risk that it will have to reimburse the bank for making a payment that was unjustifiably demanded. The bank's risk of loss is also increased because, unlike a bank issuing a traditional letter of credit, it receives no bill of lading") (footnotes omitted); Gerald T. McLaughlin, *Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy*, 43 Ohio St. L. J. 1, 6 (1982) ("The standby letter of credit functions differently from the commercial letter of credit. The latter is used in the sale of goods transaction as a payment device; the former is used in the non-sales transaction as a 'guarantee' against default on contractual obligations. Depending on the circumstances, contractual obligations are either financial or non-financial in nature—that is, a contracting party will obligate himself either to pay of a guaranty which has been subject to increased usage by banks in this country during recent years. There are a variety of reasons why the use of standby letters of credit has increased. The primary reason from a legal standpoint is that our courts have held that national banks are not permitted to guarantee the obligations of another party.[6]

The national banks involved have been imaginative enough, in responding to this situation, to fashion an instrument which they contend is not an illegal guaranty but is akin to a traditional letter of credit, as a means of avoiding any legal or regulatory constraints. . . .

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a sum of money or to do or refrain from doing an act. When the contracting party has obliged himself to pay money, the standby letter will add the obligation of the bank to the obligation of the party. For example, a creditor may loan money to a debtor on certain terms. Although the debtor will promise to repay the loan, the creditor may demand a greater assurance of repayment. The creditor may request the debtor to have a bank issue in the creditor's favor an irrevocable standby letter of credit for the amount of the loan. Thus, if the debtor defaults on his payment obligation, the creditor can turn to the bank's standby or 'backup' obligation. Here the standby letter of credit 'guarantees' performance of a financial obligation—repayment of a loan—and thus functions as a 'repayment guarantee.' When a contracting party has obliged himself, on the other hand, to perform an act, the standby letter will add the financial obligation of the bank to the performance obligation of the party. In other words, if the party fails to perform, the bank will pay the beneficiary of the letter a stipulated amount of money to compensate for this failure of performance") (footnotes omitted).

[6] *See* Naegele 1975 at 657 (*citing Border Nat. Bank Of Eagle Pass, Tex. v. American Nat. Bank Of San Francisco, Cal.*, 282 F. 73, 77–78 (5th Cir. 1922), *cert. denied*, 260 U.S. 701 (1922) ("A guaranty is a promise to answer for the payment of some debt, or the performance of some obligation, in case of the default of another person, who is in the first instance liable for such payment or performance. A letter of credit confers authority upon the person to whom it is addressed to advance money or furnish goods on the credit of the writer. It is well settled that the guaranty of a national bank is ultra vires. But a national bank is bound by its letter of credit") (citations omitted). *See also id.* at 657–658 (discussion of the distinctions between traditional commercial letters of credit and standby letters of credit); Paul R. Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 Tul. L. Rev. 314, 316–317 n.10, 318 n.20 (1978–1979) ("Naegele, Unsound Banking Practices (arguing that standby letters of credit are illegal guaranties), *reprinted in* Senate Committee on Banking, Housing and Urban Affairs, Compendium of Major Issues in Bank Regulation, 94th Cong., 1st Sess. 621, 657, 662 (May 1975) [hereinafter cited as Compendium]. Mr. Naegele also testified to the same effect in First Empire v. FDIC, Civ. No. 74-468-N, as an expert witness called by the FDIC. *See* Republic Nat'l Bank v. Northwestern Nat'l Bank, 566 S.W.2d 358 (Civ. App. Tex. 1978) (affirming trial court decision that held 'guaranty' letter of credit unenforceable as ultra vires guaranty of a national bank). . . . In addition to USNB, the Franklin National Bank and Beverly Hills National Bank failures involved the use of standbys. *See* Naegele, *supra* note 10, at 666. And of course the Intra Bank failure was complicated by the unrestrained use of standbys"); Gerald T. McLaughlin, *Standby Letters of Credit and Guaranties: An Exercise in Cartography*, 34 Wm. & Mary L. Rev. 1139 ff. (1993).

> [T]he standby letter of credit is a means by which a bank permits its customer to make use of the bank's credit standing and goodwill in the customer's business. . . . [T]he bank is in effect "selling off" its credit to others. . . .[7]
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> Quite obviously, instead of "lending" its credit[] in certain transactions, the bank itself could provide funds directly to its customer. At the time the customer seeks such funds, however, the bank may not . . . wish to lend such monies.
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> [T]he use of such instruments abroad has been sanctioned owing to the

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[7] "In practice, banks are more likely to pay than to refuse to pay because doing the latter may damage their biggest asset—reputation. In many cases they even oppose applicants' applications for injunction, because 'by obtaining an injunction restraining the bank from honouring that undertaking, he [the applicant] will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity.'" *See* Ross P. Buckley & Xiang Gao, *The Development Of The Fraud Rule in Letter Of Credit Law: The Journey So Far And The Road Ahead*, 23 U. Pa. J. Int'l Econ. L. 663, 682-683 n.41 (2002); *see also* Gerald T. McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 Ohio St. L. J. 1197, 1204 n.29 (1989) (citing *Phillip Bros. v. Oil County Specialists*, 709 S.W.2d 262 (rex. Ct. App. 1986) (injunction to block payment of a standby letter of credit granted because the inventory of goods covered by the letter of credit was virtually worthless)).

Also, it has been noted:

> Standby credits normally expire after one year. Yet, the underlying contract obligation that the credit secures may run for multiple years. In these transactions, therefore, the credit's beneficiary insists that the credit renew automatically for one year after its stated expiry. Issuers are willing to issue such an "evergreen" letter of credit and provide that the letter of credit undertaking renews automatically on the anniversary of its issue. Issuers retain the right to terminate the standby, however, by giving notice of their election to terminate a number of days, usually 30 or 60, in advance of the initial or subsequent anniversary. The credit's term providing for the renewal is the "evergreen clause."
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> The issuer's notice of intention not to renew gives the beneficiary and the applicant an opportunity to arrange for a substitute credit. Not infrequently, however, the issuer's decision not to renew is prompted by the applicant's weakened financial condition, a condition that prevents the applicant from securing a new standby.
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> From the beginning, beneficiaries know, of course, that such an eventuality is possible; and they insist at the outset that the evergreen clause contain a provision permitting the beneficiary to draw for the full amount of the credit upon receipt of the issuer's notice of non-renewal.

See John F. Dolan, *Of Competing Claims to Excess Letter of Credit Proceeds*, 125 BANKING L. J. 776, 777–778 (February 2008) (footnotes omitted).

> fact that the laws of several countries authorize banking institutions chartered thereunder to engage in such undertakings. Accordingly, it has been determined that American banks would be at a severe competitive disadvantage if their foreign counterparts were permitted to guarantee certain transactions, while American banks competing for the same business were prohibited from doing so. It is questionable, however, whether there has ever been a conscious assessment of the risks which attend foreign transactions of this nature vis-à-vis the benefits derived therefrom.[8]
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> . . .
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> Banks are special institutions subject to rules designed to assure their soundness for the benefit of depositors and to maintain public confidence in the banking system. The potential bank liability on a standby letter of credit, and consequent risk of loss to the depositors and shareholders of the bank, is just as real as if the transaction had been a typical lending transaction by the bank.[9]

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[8] *See* Naegele 1975 at 658–662.

Whether a standby letter of credit involves domestic transactions only, or is foreign in nature, ideally the following is true:

> For the expectations of the parties to be satisfied in the standby credit transaction, there will be no payment. The buyer will not default on its mortgage, the construction will proceed to completion without problems, a takeout lender will pay off City's construction loan, and City will release the standby or let it expire by its terms without any draw.

See John F. Dolan, *Letter of Credit Disputes Between the Issuer and Its Customer: The Issuer's Rights under the Misnamed "Bifurcated Standard,"* 105 BANKING L.J. 380, 382 (1988).

[9] It has been stated:

> [T]he insolvency of a letter of credit issuer should arise only in the rare case; and, in fact, such bank insolvencies are rare but tend to arise periodically when the banking system faces stress. Careful beneficiaries guard against taking as security a letter of credit issued by a financially weak bank. It is common practice for beneficiaries that agree to take a standby letter of credit to insist that they have the privilege of rejecting any proffered standby from a bank whose credit standing they question. In all events, bank insolvency risk must be the first issue that a beneficiary addresses when it asks its applicant counterparty to provide security for an unexecuted promise.
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> **INSURED DEPOSITS: CLAIMS AGAINST THE FAILED BANK'S RECEIVER**
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> **Standby Credit as Beneficiary's Insured Deposit**
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> Section 1813(l)(1) of the FIRREA defines an insured "deposit" to include a "letter of credit." In *FDIC v. Philadelphia Gear Corp.*, however, the Court, relying on legislative history and agency interpretation of that language, limited the definition to letters of credit

. . .

> It is appropriate to focus on the use of guaranties in the standby letter of credit context because banks are reluctant to disclose fully or describe the various types of guaranty transactions, and because it presents a useful illustration of a high risk situation once one is able to cut through the complexities of the transactions involved.[10]

> backed by "hard assets." Because the credit in the *Philadelphia Gear* case was an unsecured, non-negotiable, contingent promissory note, the court reasoned that the letter of credit was not backed by any hard assets and that beneficiary could not make a claim as an insured depositor.
>
> . . .
>
> In a leading case, *First Empire Bank—New York v. FDIC*, the court held that a letter of credit is a provable claim if the claim arises before the issuer's insolvency, does not depend on post insolvency facts, and the total liability under the credit is certain at the time of suit against the FDIC. The FDIC made a reasonable argument to the effect that the beneficiary of a standby credit has no damages if at the time of the insolvency of the issuer, the beneficiary had not drawn on the credit, usually, in virtue of the fact that it could not satisfy the requirements of a draw. If, by way of illustration, a standby secured payment of interest and principal on a municipal bond and if at the time of the issuer's insolvency there had been no default on the bond, the beneficiary could not draw on the standby and assert in its required documents that there had been a default. The beneficiary of that credit holds no provable claim and shouldn't hold a provable claim. It may not suffer any loss even when the FDIC has announced that it will not honor the credit.
>
> *First Empire* and subsequent cases ruled, however, that if the beneficiary could satisfy the conditions of the credit at the time of suit and if the FDIC had not by then disposed of all of the failed bank's assets, the beneficiary's claim is provable. The beneficiary of a credit issued by a failed bank, then, may not necessarily recover the face amount of the credit by drawing on the credit, but it might be able to maintain a claim.

See John F. Dolan, *Insolvency in Letter of Credit Transactions—Part II*, 132 BANKING L. J. 243, 244, 246 (May 2015) (footnotes omitted); *see also FDIC v. Philadelphia Gear Corp.*, 476 US 426, 106 S. Ct. 1931, 90 L. Ed. 2d 428 (1986) and *First Empire Bank—New York v. FDIC,* 634 F.2d 1222 (9th Cir. 1980), *cert. denied*, 452 U.S. 906 (1981).

Professor Dolan added: "The case [*FDIC v. Philadelphia Gear*] is a pre-FIRREA case, but its reasoning remains good." *See* Dolan, *Insolvency in Letter of Credit Transactions—Part II*, 132 BANKING L. J. 244 n.4.

[10] As stated in the Manual of Examination Policies published by the Federal Deposit Insurance Corporation ("FDIC"):

> The two primary areas of risk relative to [Standby Letters of Credit] SBLCs are credit risk (the possibility of default on the part of the account party), and *funding risk (the potential inability of the bank to fund a large draw from normal sources).*

See infra n.17 (emphasis added); *see also* https://www.fdic.gov/regulations/safety/manual/section3-8.pdf, Section 3.8-2 (emphasis in original).

The FDIC is a U.S. government corporation providing deposit insurance to depositors in U.S.

> . . .
>
> A fee of from one-quarter of one percent to one percent, or as much as $1 million on a $100 million standby letter of credit financing, is collected by the bank for its services; and the bank is not required to commit any funds of its own, unless a default occurs.
>
> . . .
>
> [O]ne large brokerage house which has been prominently involved with standby letter of credit transactions in recent years noted that such an instrument "removes from investor consideration any questions of collateral values or the necessity of examining and understanding the details of a complex . . . contract." Third parties rely upon the bank's capacity and willingness to perform in the event of default. The reasonableness of such reliance depends, in part, on the quantity and

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commercial banks and savings associations. *See, e.g.*, https://www.fdic.gov/.

The various uses of standby letters of credit are limited *almost* by one's imagination only. For example, it has been noted:

> Letters of credit are advantageous to the municipality seeking a means of prompt payment to guarantee performance of a land development agreement. In order to serve the mutual interests of all parties, the lender issuing the credit should recognize that a standby letter of credit is not a secondary obligation contingent upon the failure of the developer to perform. The credit is strictly enforced against the issuer, and the issuer has no obligation to inquire as to the underlying transaction. Any presentment under the credit requires strict adherence to sight draft or documentary requirements.
>
> The drafter of a letter of credit should keep the following principles in mind:
>
> 1. The underlying agreement must not conflict with the terms of the letter of credit. Expiration dates should be coordinated, allowing the municipality to ascertain the default and to exercise its drawing rights before the letter of credit expires.
>
> 2. The letter of credit must not call for documents that the municipality cannot supply. The letter should specify in detail the nature of the default and the precise events giving rise to the right to draw. The underlying documents and the letter of credit should correspond exactly.
>
> 3. Irrevocability and transferability of the right to draw must be expressly stated.
>
> 4. To avoid disputes over the accuracy of required documents, the parties should use the standby letter of credit, which is available by sight drafts and does not require a specific documentary presentation.
>
> With the foregoing principles in mind, the well-drafted letter of credit in a land development agreement with a municipality nearly eliminates the possibility of litigation, and thereby serves the best interests of the parties by assuring the project's undelayed completion, without risk to the municipal treasury.

See James P. Downey, *The Letter of Credit as Security for Completion of Streets, Sidewalks, and Other Bonded Municipal Improvements*, 23 U. Rich. L. Rev. 161, 170–171 (1988).

quality of information which is readily available to the public; however, such transactions are presumed to be exempt presently from registration and disclosure under the securities laws.[11]

. . .

For standby letters of credit and other bank guaranties to be considered of value, there must be public confidence in the bank's capacity to perform promptly and completely in the event a bank's customer defaults on the underlying obligation. In part, this public confidence is engendered by the presence of the Federal Reserve, the Comptroller [of the Currency], the FDIC and the state bank supervisory agencies. These regulatory bodies are viewed by the public to be constantly monitoring and controlling bank risk exposure, in order to insure the safety and soundness of such institutions. Recent events and practices indicate, however, that the protection and assurances provided by the regulators are largely illusory when it comes to standby letters of credit.

. . .

[T]he Federal presence in banking alone enables standby letters of credit to distort the functioning of the marketplace. Certainly, risk is a prime factor which an investor weighs in determining both the amount of his investment and the expected return thereon. A standby letter of credit, however, acts to shift the risk of loss away from the investor, and places it on the bank. The purchaser can ignore effectively the actual borrower's financial condition and rely solely on the presumed safety and soundness of the bank. This failure to investigate the issuer of commercial paper[, for example,] may cause a distortion in the flow of investment funds, and result in a flow away from those investments which the marketplace would otherwise make, based on a comparative analysis of risk and return.[12]

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[11] *But see infra* n.25.

[12] Indeed, it has been noted:

Some beneficiaries take credits issued by non-commercial banks—a perilous way to take security in most cases. Under the UCC, any person except an individual securing its own personal, family or household obligations, may be a letter of credit "issuer." One cannot make the point too often that beneficiaries who take letters of credit from non-banks are engaging in risky activity. Letters of credit are idiosyncratic undertakings—atypical obligations. Banks that engage in trade finance (international lending) and domestic commercial lending in the many guises where standby credits serve commercial parties are fitting candidates for letter of credit issuance. It is essential for those banks that engage in that activity to issue letters of credit and to have them accepted. It is also essential that letter

Indeed, bank guaranties bear some similarities to loan guaranties issued by the Federal Government. Congress has determined that, for reasons of articulated public policy, loans should be made to certain classes of borrowers in order to accomplish various policy goals through such programs as VA, FHA, and SBA. Rather than imposing statutory requirements that lending institutions and other investors make specific investments to accomplish these policy goals, congressional programs attempt to make such investments attractive by transferring all or a portion of the risk of loss to the Federal Government. Standby letters of credit also make funds available for certain needs at rates not otherwise obtainable, but with one important distinction: their use, and the use of guaranties generally, has no connection with the effectuation of defined public policies.

. . .

When the U.S. National Bank of San Diego (USNB) collapsed, in late 1973, the domestic and foreign ramifications were enormous. Out of approximately $100 million in letters of credit outstanding, $91 million purportedly represented standby letters of credit which guaranteed the payment of certain obligations of the bank's customers or companies controlled by [the bank's principal shareholder,] C. Arnholt Smith.[13]

. . .

As mentioned above, for a relatively small fee, banks have been willing to extend their credit to bank customers and thereby assume certain risks which may be out of proportion to their capital or deposit bases.

Since bank credit is being advanced rather than funds, the banks

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of credit issuers be familiar with those branches of lending and with letter of credit practice and law, practice and law that take account of the letter of credit's idiosyncratic features. Generally, cautious commercial parties will not take letters of credit issued by thrifts, finance companies that do not customarily issue letters of credit, or business corporations. There is, moreover, considerable fraud in letter of credit issuance, fraud which commercial parties can usually avoid by limiting their letter of credit dealings to commercial banks experienced in letter of credit law and practice.

See John F. Dolan, *Insolvency in Letter of Credit Transactions—Part II*, 132 Banking L. J. 243, 248 (May 2015) (footnote omitted).

[13] The author testified as an expert witness for the FDIC with respect to standby letters of credit and other bank guaranties, in litigation arising from the collapse of this bank—which at the time was the largest bank failure in U.S. history. *See also supra* n.2 (Katskee discussion), and *infra* n.27.

involved may have a tendency to ignore traditional lending ratios even though such considerations may be just as important or even more important in a guaranty transaction—in terms of liquidity needs and similar factors—than they would be in an ordinary loan transaction. If such a bank is required to honor its commitments under a guaranty and it cannot realize readily a corresponding amount of funds from the party on whose behalf the guaranty was issued originally, or some other party, the bank may find itself in a severe liquidity bind especially if it is heavily loaned-out in other areas.

. . .

[W]hen the Federal Reserve began to pursue a tight money policy some years ago, in an effort to combat inflation, certain banks began to issue standby letters of credit in connection with the sale of commercial paper. Thus, rather than the bank issuing a certificate of deposit and lending the proceeds thereof to its customer, the customer obtained the funds directly in the commercial paper market on the strength of the bank's commitment to honor the commercial paper in the event the customer failed to do so. In this way, banks avoided reserve requirements that would have applied if a certificate of deposit-loan transaction had been consummated. Because the use of reserve requirements is an important tool of money policy and credit control, the Federal Reserve's efforts in this regard tended to become ineffective to the extent that banks relied on such "escape hatches".

. . .

[S]tandby letters of credit and other bank guaranties may precipitate a severe liquidity crisis which could have disastrous consequences for the particular bank or banks involved, as well as for our banking system as a whole. Such problems may arise because a major bank has been obligated to perform under a guaranty and must honor its commitment, at a time when it is unable to realize immediately the monies owed to it on other obligations which are outstanding.[14]

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[14] *See id.* at 626–629, 633, 634, 635, 636, 637–638, 642, 653–654, 664, 670.

For additional discussions of standby letters of credit and other bank guaranties—and related issues—*see, e.g.*, John F. Dolan, *The Role of Attorney's Fees in Letter of Credit Litigation*, 133 BANKING L. J. 555 (November/December 2016); John F. Dolan, *The Domestic Standby Letter of Credit Desk Book for Business Professionals, Bankers, and Lawyers* (Matthew Bender 2015); John F. Dolan, *Insolvency in Letter of Credit Transactions—Part III*, 132 BANKING L. J. 287 (June 2015); John F. Dolan, *Insolvency in Letter of Credit Transactions—Part II*, 132 BANKING L. J. 243 (May 2015); John F. Dolan, *Insolvency in Letter of Credit Transactions—Part I*, 132 BANKING L.

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J. 195 (April 2015); John F. Dolan, *Whatever Happened to the Poor Old Doctrine of Negotiability?* 130 Banking L. J. 136 (February 2013); John F. Dolan, *Letter of Credit Undertakings and Suretyship Contracts: Did the Fifth Circuit Slip in Express Blower, Inc. v. Earthcare, LLC?* 129 Banking L. J. 291 (April 2012); John F. Dolan, *Concerns Regarding the Ontario Court's Judgment in the Nareerux Case*, 128 Banking L. J. 116 (February 2011); James J. White, *Implementing the Standby Letter of Credit Convention with the Law of Wyoming*, 1 Geo. Mason J. Int'l Comm. L. 1 (2010); John F. Dolan, *Of Competing Claims to Excess Letter of Credit Proceeds*, 125 Banking L. J. 776 (February 2008); John F. Dolan, *The Law of Letters of Credit: Commercial and Standby Credits* (A.S. Pratt & Sons, rev. ed. 2007); Carter H. Klein, *Standby Letter of Credit Rules and Practices Misunderstood or Little Understood by Applicants and Beneficiaries*, 40 U.C.C.L.J. 125 (2007); Ross P. Buckley & Xiang Gao, *The Development Of The Fraud Rule in Letter Of Credit Law: The Journey So Far And The Road Ahead*, 23 U. Pa. J. Int'l Econ. L. 663 (2002); John F. Dolan, *Security Interests in Letter-of-Credit Rights*, 74 Chi.-Kent L. Rev. 1035 (1999); Gerald T. McLaughlin, *Standby Letters of Credit and Guaranties: An Exercise in Cartography*, 34 Wm. & Mary L. Rev. 1139 (1993); Gerald T. McLaughlin, *Letters of Credit and Illegal Contracts: The Limits of the Independence Principle*, 49 Ohio St. L. J. 1197 (1989); John F. Dolan, *Letter of Credit Disputes Between the Issuer and Its Customer: The Issuer's Rights under the Misnamed "Bifurcated Standard,"* 105 Banking L.J. 380 (1988); James P. Downey, *The Letter of Credit as Security for Completion of Streets, Sidewalks, and Other Bonded Municipal Improvements*, 23 U. Rich. L. Rev. 161 (1988); Henry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits*, 3 Colum. Bus. L. Rev. 705 (1988); Christopher Leon, *Letters of Credit: a Primer*, 45 Md. L. Rev. 432 (1986); John F. Dolan, *Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Goldsmiths in Lombard Street?)*, 7 Cardozo L. Rev. 1 (1986); John F. Dolan, *Strict Compliance with Letters of Credit: Striking a Fair Balance*, 102 Banking L. J. 18 (1985); Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. Chi. L. Rev. 218 (1985); A. Robert Thorup, *Injunctions Against Payment of Standby Letters of Credit: How Can Banks Best Protect Themselves?* 101 Banking L. J. 6 (1984); Jim L. Banks, The Standby Letter of Credit: What It Is and How To Use It, 45 Mont. L. Rev. 71 (1984); Reade H. Ryan, Jr., *Letters of Credit Supporting Debt for Borrowed Money: The Standby as Backup*, 100 Banking L. J. 404 (1983); George A. Hahn and Jeffrey L. Schwartz, *Letters of Credit Under the Bankruptcy Code*, 16 U.C.C.L.J. 91 (1983); Gerald T. McLaughlin, *Standby Letters of Credit and Penalty Clauses: An Unexpected Synergy*, 43 Ohio St. L. J. 1 (1982); Jonathan D. Thier, *Letters of Credit: A Solution to the Problem of Documentary Compliance*, 50 Fordham L. Rev. 848 (1982); Bernard S. Wheble, *'Problem Children'—Standby Letters of Credit and Simple First Demand Guarantees*, 24 Ariz. L. Rev. 301 (1982); Boris Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 Ariz. L. Rev. 319 (1982); George Weisz & Jonathan I. Blackman, *Standby Letters of Credit After Iran: Remedies of the Account Party*, 1 U. of Ill. L. Rev. 355 (1982); Douglas G. Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. Chi. L. Rev. 130 (1982); H.J. van der Vaart, *Standby Letters of Credit and the Problem of Bad Faith Calls*, 8 Yale J. Int'l L. 36 (1981); Joseph D. Becker, *Standby Letters of Credit and the Iranian Cases: Will the Independence of the Credit Survive?* 13 U.C.C.L.J. 335 (1981); Herbert A. Getz, Comment, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases,* 21 Harv. Int'l L.J. 189 (1980); Tim A. Forgerson, *Standby Letter of Credit—True Letters of Credit or Guaranties: Republic National Bank v. Northwest National Bank*, 33 SMU L. Rev. 1301 (1979); Richard A. Lord, *The No-Guaranty Rule and the Standby Letter of Credit Controversy*, 96 Banking L. J. 46 (1979); Paul R. Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 Tul.

According to figures published by the Fed, the aggregate amount of "Financial standby letters of credit and foreign office guarantees" in the third quarter of 2018 stood at more than a half-trillion dollars—$534.8 billion, to be exact—which seems exceptionally low.[15]

THE LAW TODAY

The statute that was to be amended pursuant to the proposed legislation in 1975, 12 U.S. Code § 82, was repealed in 1982.[16] Today, 12 C.F.R. § 337.2 and other provisions[17] govern standby letters of credit—and it defines them as:

L. Rev. 314 (1978–1979); Henry Harfield, *The Letter of Credit Debate*, 94 Banking L.J. 293 (1977); Melvin R. Katskee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 Banking L. J. 697 (1975); Paul R. Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 Stan. L. Rev. 716 (1973); Henry Harfield, *The Increasing Domestic Use of the Letter of Credit*, 4 U.C.C.L.J. 251 (1972); H.J. Arnold, Jr. & E. Bransilver, *The Standby Letter of Credit—The Controversy Continues*, 10 U.C.C.L.J. 272 (1972).

[15] *See* https://www.federalreserve.gov/releases/efa/off-balance-sheet-items.pdf (December 21, 2018).

[16] *See* Pub. L. 97-320, title IV, § 402, Oct. 15, 1982, 96 Stat. 1510; *see also* https://www.law.cornell.edu/uscode/text/12/82.

[17] *See* https://www.law.cornell.edu/cfr/text/12/337.2.

See also Comptroller's Handbook, published by the Office of the Comptroller of the Currency ("OCC"), which is an independent bureau within the U.S. Department of the Treasury that serves to charter, regulate and supervise all national banks and thrift institutions and the federally-licensed branches and agencies of foreign banks in the U.S. (*see, e.g.*, https://www.occ.treas.gov/ and https://en.wikipedia.org/wiki/Office_of_the_Comptroller_of_the_Currency), Version 1.1 (October 15, 2018), https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/trade-finance-services/pub-ch-trade-finance.pdf:

> There are two broad types of letters of credit that banks use to facilitate trade finance: commercial documentary letters of credit and standby letters of credit.
>
> **Commercial Documentary Letters of Credit**
>
> The commercial documentary letter of credit[5] is commonly used to finance a commercial contract for the shipment of goods from seller to buyer. This versatile instrument may be used in nearly every type of trade finance transaction and provides for prompt payment to the exporter when the goods are shipped and conforming documents are presented to the bank. According to the Uniform Commercial Code (UCC), all letters of credit must be issued
>
> - in favor of a specific beneficiary (the exporter);
> - for a specific amount of money;
> - in a form clearly stating how payment to the beneficiary is to be made and under what conditions; and
> - with a specific expiration date.

(Text continued on page 217)

[Footnote 5: "The term is also known as commercial letters of credit, documentary letters of credit, documentary credit, or simply letters of credit. In trade, when the term 'letters of credit' is used, it is generally understood that it refers to commercial letters of credit. The term does not include standby letters of credit, which are referred to as standby."]

Individual banks may use terms such as "import letter of credit" and "export letter of credit," but these terms are not separate products. They reflect the different positions of an importer and exporter in the use of the same letter of credit for a transaction.

To the importer, the letter of credit allows the issuing bank to substitute its creditworthiness for that of its client, the importer. At a client's request, the issuing bank pays stated sums of money to the exporters against stipulated documents transferring ownership of the goods. A letter of credit does not eliminate the risk of fraud or deception by an unscrupulous exporter against an importer, because the bank deals only in documents and does not inspect the goods themselves.

If the issuing bank is not local to the exporter or otherwise acceptable to the exporter, the exporter may insist that the issuing bank obtain confirmation of credit from a bank local to or acceptable to the exporter. The confirming bank then becomes directly obligated to the exporter as if it were an issuing bank and has rights, obligations, and risks (for example, country) with respect to the issuing bank as if the issuing bank were a letter of credit applicant.

The success of a commercial letter of credit transaction depends heavily on documentation and resolution of document discrepancies. A single transaction requires many different types of documents, and failure to obtain conforming documents or to resolve document discrepancies, especially material errors, may cause the bank to lose its protection and rights and suffer financial loss.

Payments under a commercial letter of credit do not necessarily lead to an extension of credit. The bank prearranges with the client the method by which the letter of credit will be funded, normally by a debit to an existing bank account or by using a preapproved credit facility.

For additional information about commercial letters of credit and the process flow relating to the issuance of commercial letters of credit, see appendix A and appendix C, respectively. For the various categories of commercial letters of credit, refer to the glossary for descriptions.

Standby Letters of Credit

Standby letters of credit are common bank instruments that also may be used in trade finance. For example, a bank issues a standby letter of credit on behalf of a client involved in a long-term project. Normally that project stipulates that the client adhere to certain performance measures. The standby letter of credit is used to ensure payment to the beneficiary if the bank's client fails to perform as contractually agreed. A standby letter of credit is not used to finance the purchase or shipment of goods. (Updated October 15, 2018)

Commercial Letters of Credit vs. Standby Letters of Credit

There are many differences between commercial letters of credit and standby letters of credit. Commercial letters of credit are short-term payment instruments for financing

(Text continued on page 217)

international trade, while standby letters of credit can be written for any purpose or term.

Under all letters of credit, the banker expects the customer to be financially able to meet its commitments. A banker's payment under a commercial letter of credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. The bank makes payment on a standby letter of credit, however, only when the customer has defaulted on its primary obligation and probably will be unable to reimburse the bank immediately.

A standby letter of credit transaction holds more potential risk for the issuing bank than does a commercial letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit typically retains nothing of value to protect it against loss, whereas a commercial letter of credit provides the bank with title to the goods being shipped. (Updated October 15, 2018)

Governing Rules and Practices

The rules governing letters of credit transactions in the United States derive from article 5 of the UCC, "Letters of Credit," and the Uniform Customs and Practice for Documentary Credits (UCP), published by the ICC. Each U.S. state incorporates the UCC into its statutory scheme, but the states differ in how much of the UCC they incorporate. Thus, state laws for letters of credit vary, as do the laws of foreign countries, and it is important for bank personnel to be knowledgeable about applicable laws. (Updated October 15, 2018)

The UCP does not carry the force of law but instead is a set of generally accepted ground rules developed over the years for letter of credit transactions. The rules are accepted by the vast majority of commercial letter of credit issuers. For the UCP rules to apply, the commercial letter of credit must expressly indicate that it is subject to the rules. The rules are then contractually binding on all parties to the commercial letter of credit unless its terms and conditions expressly exclude or modify a rule.

The generally accepted international practices governing standby letters of credit are contained in the UCP and the International Standby Practices, 1998 edition (ISP98), also published by the ICC. ISP98 provides separate rules for standby letters of credit that are more specialized than those outlined in the UCP.

For information on accounting practices for letters of credit, see appendix G.

Guarantees

National banks may issue guarantees and sureties in certain circumstances, including when the bank has a substantial interest in the performance of the transaction involved or the bank has a segregated deposit sufficient in amount to cover its potential liability. Additionally, national banks may guarantee obligations of their customers, subsidiaries, or affiliates that are financial in character, provided the amount of the bank's financial obligation is reasonably determinable and otherwise consistent with applicable law. Under certain circumstances, foreign branches of national banks may exercise powers exercised by banks in the host country, including guarantees. Like standby letters of credit, guarantees represent the undertaking of the bank, as issuing bank, to make payment to a third party on behalf of a client upon the occurrence of a predefined event. Normally, the client agrees to reimburse the bank for amounts paid out under the guarantee. FSAs, subject to certain conditions, may enter into sureties and guarantees. For additional information on guarantees, see appendix D. (Updated October 15, 2018)

(Text continued on page 217)

See id. at pp. 4–6; *see also* James J. White, *Implementing the Standby Letter of Credit Convention with the Law of Wyoming*, 1 Geo. Mason J. Int'l Comm. L. 1 (2010) and John F. Dolan, *Security Interests in Letter-of-Credit Rights*, 74 Chi.-Kent L. Rev. 1035, 1036 n.3 (1999) ("Prior to January 1, 1999, most letters of credit, whether commercial or standby, issued in the United States were expressly subject to UCP 500. It is the obvious intent of the banking industry, which participated in the fashioning of ISP98, that in the future standby credits should be issued subject to ISP98, while commercial credits shall be issued subject to UCP 500").

With respect to the OCC's examination procedures of those financial institutions that it regulates, the Comptroller's Handbook states regarding standby letters of credit, in pertinent part:

> 21. Determine compliance with lending limits on standby letters of credit under 12 CFR 32.2(g) and 12 CFR 32.3.
>
> - Review letters of credit to determine which are standby letters of credit subject to 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u) (lending limits).
> - Determine whether any identified standby letter of credit represents an obligation to the beneficiary on the part of the issuing bank to repay money borrowed by, advanced to, or advanced for the account of the account party; to make payment on account of any indebtedness undertaken by the account party; or to make payment if the account party defaults in the performance of an obligation.
> - Determine whether the credit of the account party under any standby letter of credit is analyzed as thoroughly as that of an applicant for an ordinary loan.
> - Combine standby letters of credit with any other of the issuing bank's nonaccepted loans to the account party for the purpose of applying 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u).
> - Identify standby letters of credit subject to a nonrecourse participation agreement with another bank or banks where the limits of 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u), apply to the issuer and each participant.
> - Determine which standby letters of credit are not subject to 12 USC 84 and, for FSAs, 12 USC 84 and 1464(u) because
>   - before or at the time of issuance, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit;
>   - before or at the time of issuance, the issuing bank has set aside sufficient funds in a segregated deposit account clearly earmarked to cover the bank's maximum liability under the standby letter of credit; or
>   - the OCC has found that a particular standby letter of credit or class of standby letters of credit will not expose the issuer to as much loss as a loan to the account party.

See id. at 38. *See also id.* at 86:

> **Other Legal Issues**
>
> Examiners should be aware of the laws that limit the amounts of certain kinds of letters of credit. Standby letters of credit and guarantees, which are defined as contractual commitments to advance funds, are subject to the limits of 12 USC 84 and, for FSAs, both

[A]ny letter of credit, or similar arrangement however named or

12 USC 84 and 12 USC 1464(u), and must be combined with any other nonaccepted loans to the account party by the issuing bank. (Updated October 15, 2018)

See also "Comptroller of the Currency Interpretive Ruling," 12 CFR § 7.1016(b)(iii)(A) (2008).

Similarly, the FDIC's Manual of Examination Policies states with respect to "Off-Balance Sheet Lending Activities," and more specifically, "Letters of Credit":

> **Standby—**A standby letter of credit (SBLC) is an irrevocable commitment on the part of the issuing bank to make payment to a designated beneficiary. It obligates the bank to guarantee or stand as surety for the benefit of a third party. SBLCs can be either financial-oriented, where the account party is to make payment to the beneficiary, or performance-oriented, where a service is to be performed by the account party. SBLCs are issued for a variety of purposes, such as to improve the credit ratings for issuers of industrial development revenue bonds and commercial paper; to provide back-up facilities for loans granted by third parties; to assure performance under construction and employment contracts; and to ensure the account party satisfies financial obligations payable to major suppliers or under tax shelter programs.
>
> FASB Interpretation No. (FIN) 45, *Guarantor's Accounting and Disclosure Requirements of Guarantees, Including Indirect Guarantees of Indebtedness of Others*, clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 applies to standby letters of credit, both financial and performance. Commercial letters of credit are not considered guarantees, and therefore, are not subject to FIN 45.
>
> An SBLC differs from a commercial letter of credit in that the latter facilitates the sale of goods and is expected to be drawn upon by the beneficiary in the normal course of business, whereas the SBLC is not, generally, expected to be used unless the account party defaults in meeting an obligation to the beneficiary.
>
> While no particular form is required for a SBLC, it should contain certain descriptive information. First, there should be a separate binding agreement wherein the account party agrees to reimburse the bank for any payments made under the SBLC. The actual letter should be labeled as a "standby letter of credit," be limited in amount, cover a specific time period, and indicate the relevant information that must be presented to the bank before any draws will be honored due to the account party's failure to perform. Since the bank is not a party to the contract between the account party and the beneficiary, the SBLC should not be worded so as to involve the bank in making determinations of fact or law at issue between the parties.
>
> The two primary areas of risk relative to SBLCs are credit risk (the possibility of default on the part of the account party), and funding risk (the potential inability of the bank to fund a large draw from normal sources). An SBLC is a potential extension of credit and should be evaluated in a manner similar to evaluating a direct loan. The risk could be significant under an SBLC given its irrevocable nature, especially if the SBLC is written for an extended time period. Deterioration in the financial position of a customer could allow for a direct loan commitment to be rescinded if the commitment contained a "material adverse change" clause; however, such would not be applicable with an SBLC since it is an irrevocable agreement between the bank and the beneficiary. Some SBLCs may have an automatic

(Text continued on page 219)

renewal provision and will roll over until notice of cancellation is given by either the bank or beneficiary prior to a maturity date. However, notice given by the bank usually allows the beneficiary to draw under the letter irrespective of whether the account party is performing.

SBLCs, like loans, can be participated and syndicated. Unlike loans, however, the sale of SBLC participations does not diminish the total contingent liability of the originating bank. The name of the originating bank is on the actual letter of credit, and it must therefore honor all drafts whether or not the participants are willing or able to disburse their pro rata share. Syndications, on the other hand, represent legal apportionments of liability. If one of the banks fails to fulfill its obligation under the SBLC, the remaining banks are not liable for that bank's share.

Section 337.2(d) of the FDIC Rules and Regulations requires banks to maintain adequate controls and subsidiary records of SBLCs comparable to records maintained on direct loans so that a bank's total liability may be determined at all times. Banks are also required to adequately reflect all SBLCs on published financial statements. Credit files should be kept current as to the status of SBLCs, and reports should be provided on a regular basis to the directors on the volume of standby letters, with a breakdown by type, as well as by industry.

This report will enable any concentrations to be monitored so that steps can be taken to reduce any undue exposure should economic or financial trends so dictate.

It may be appropriate to adversely classify or Special Mention an SBLC if draws under the SBLC are probable and credit weaknesses exist. For example, deterioration in the account party's financial standing could jeopardize performance under the letter of credit and result in a draw by the beneficiary. If a draw under an SBLC were to occur, the offsetting loan to the account party could then become a collection problem, especially if it was unsecured.

See https://www.fdic.gov/regulations/safety/manual/section3-8.pdf, Section 3.8-2 to 3.8-3 (emphasis in original); *see also* James J. White, *Implementing the Standby Letter of Credit Convention with the Law of Wyoming*, 1 Geo. Mason J. Int'l Comm. L. 1 (2010).

In 12 CFR 208.24, the Fed sets forth its rules:

§ 208.24 Letters of credit and acceptances.

(a) ***Standby letters of credit.*** For the purpose of this section, standby letters of credit include every letter of credit (or similar arrangement however named or designated) that represents an obligation to the beneficiary on the part of the issuer:

(1) To repay money borrowed by or advanced to or for the account of the account party; or

(2) To make payment on account of any evidence of indebtedness undertaken by the account party; or

(3) To make payment on account of any default by the party procuring the issuance of the letter of credit in the performance of an obligation.

A standby letter of credit does not include: (1) Commercial letters of credit and similar instruments, where the issuing bank expects the beneficiary to draw upon the issuer, and which do not guaranty payment of a money obligation; or (2) a guaranty or similar obligation issued by a foreign branch in accordance with and subject to the limitations of 12 CFR part 211 (Regulation K).

(b) ***Ineligible acceptance.*** An ineligible acceptance is a time draft accepted by a bank, which

> described, which represents an obligation to the beneficiary on the part of the issuer: (1) To repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default (including any statement of default) by the account party in the performance of an obligation.[18] The term *similar arrangement* includes the creation of an acceptance or similar undertaking.[19]

They are restricted as follows:

> A standby letter of credit issued by an insured State nonmember bank shall be combined with all other standby letters of credit and all loans for purposes of applying any legal limitation on loans of the bank (including limitations on loans to any one borrower, on loans to affiliates of the bank, or on aggregate loans); *Provided, however*, That if such standby letter of credit is subject to separate limitation under applicable State or federal law, then the separate limitation shall apply in lieu of the loan limitation.[20]

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does not meet the requirements for discount with a Federal Reserve Bank.

(c) ***Bank's lending limits.*** Standby letters of credit and ineligible acceptances count toward member banks' lending limits imposed by state law.

(d) ***Exceptions.*** A standby letter of credit or ineligible acceptance is not subject to the restrictions set forth in paragraph (c) of this section if prior to or at the time of issuance of the credit:

(1) The issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit; or

(2) The party procuring the issuance of a letter of credit or ineligible acceptance has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit or ineligible acceptance.

See https://www.law.cornell.edu/cfr/text/12/208.24; *see also* https://www.federalreserve.gov/bankinforeg/reghcg.htm and https://en.wikipedia.org/wiki/Federal_Reserve ("Federal Reserve")

[18] "As defined in this paragraph (a), the term *standby letter of credit* would not include commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer, which do not 'guaranty' payment of a money obligation of the account party and which do not provide that payment is occasioned by default on the part of the account party." *See* https://www.law.cornell.edu/cfr/text/12/337.2 n.1 (emphasis in original).

[19] *See* 12 C.F.R. § 337.2(a); *see also* https://www.law.cornell.edu/cfr/text/12/337.2 (emphasis in original) and *Kaysville City v. F.D.I.C.*, 557 Fed.Appx. 719, 723 n.1 (10th Cir. 2014).

[20] "Where the standby letter of credit is subject to a non-recourse participation agreement with another bank or other banks, this section shall apply to the issuer and each participant in the same manner as in the case of a participated loan." *See* 12 C.F.R. § 337.2(b); *see also*

Disclosure is required:

> Each insured State nonmember bank must maintain adequate control and subsidiary records of its standby letters of credit comparable to the records maintained in connection with the bank's direct loans so that at all times the bank's potential liability thereunder and the bank's compliance with this section may be readily determined. In addition, all such standby letters of credit must be adequately reflected on the bank's published financial statements.[21]

In addition to those judicial decisions that have been cited earlier in this article's footnotes—and in the law review articles and other authorities cited[22]—it is worth repeating: the various uses of standby letters of credit are limited *almost* by one's imagination only.[23] For example, it should be noted:

> When a tenant's landlord draws on a standby LC securing rent, the tenant may argue that in virtue of landlord's defaults under the lease, tenant does not owe the rent. When Seller draws on a standby securing invoices, Buyer may claim that Seller's shipment did not conform and,

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https://www.law.cornell.edu/cfr/text/12/337.2.

Exceptions are set forth in 12 C.F.R. § 337.2(c), which states:

All standby letters of credit shall be subject to the provisions of paragraph (b) of this section except where:

(1) Prior to or at the time of issuance, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit; or,

(2) Prior to or at the time of issuance, the issuing bank has set aside sufficient funds in a segregated deposit account, clearly earmarked for that purpose, to cover the bank's maximum liability under the standby letter of credit.

See also https://www.law.cornell.edu/cfr/text/12/337.5 ("§ 337.5 Exemption. Check guaranty card programs, customer-sponsored credit card programs, and similar arrangements in which a bank undertakes to guarantee the obligations of individuals who are its retail banking deposit customers are exempted from § 337.2: *Provided, however,* That the bank establishes the creditworthiness of the individual before undertaking to guarantee his/her obligations and that any such arrangement to which a bank's principal shareholders, directors, or executive officers are a party be in compliance with applicable provisions of Federal Reserve Regulation O (12 CFR part 215)"); *Federal Deposit Ins. Corp. v. Bank of Boulder*, 865 F.2d 1134. 1141–1142 (1988), *on rehearing* 911 F.2d 1466, *certiorari denied* 499 U.S. 904, 111 S.Ct. 1103, 113 L.Ed.2d 213 (Federal Deposit Insurance Corporation, as a corporation, can purchase and acquire right to draw on letter of credit from FDIC, as receiver for insolvent bank, in the course of purchase and assumption transaction, notwithstanding that letter of credit is nontransferable under state law or by its own terms. Federal Deposit Insurance Act § 2[13](c)(2)(A), 12 U.S.C.A. § 1823(c)(2)(A)).

[21] *See* 12 C.F.R. § 337.2(d); *see also* https://www.law.cornell.edu/cfr/text/12/337.2.

[22] *See, e.g., supra* n.14.

[23] *See supra* n.10.

therefore that Buyer does not owe Seller. Both of these typical arguments are efforts to raise in the LC transaction issues arising out of the underlying transaction. Those efforts should fail. Often, they do, but often they succeed in delaying or stopping payment, all to the great cost of the LC as a commercial device.[24]

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[24] *See* John F. Dolan, *The Role of Attorney's Fees in Letter of Credit Litigation*, 133 BANKING L. J. 555, 569 (November/December 2016) (footnote omitted).

A distinction is drawn between letters of credit and suretyship obligations:

The weight of authority . . . holds squarely that letters of credit are not suretyship obligations and that suretyship law does not apply to them. When a California court reached the unfortunate conclusion that a letter of credit undertaking was a suretyship obligation, the California Supreme Court responded emphatically that the court's conclusion was in error. "L]etters [sic] of credit—standby or otherwise—are not a form of suretyship, and the rights of the parties to these transactions are not governed by suretyship principles." Recently, the Ninth Circuit Court of Appeals affirmed that letters of credit are not suretyship undertakings. Writing for the Seventh Circuit Court of Appeals Judge Easterbrook characterized the "promise and premise" of letters of credit as "pay-now-argue-later devices." Writing for the 1st Circuit Court of Appeals, Judge Breyer, as he then was, announced that the "very object of a letter of credit is to provide a near foolproof method of placing money in its beneficiary's hands when he complies with the terms contained in the letter itself. . . ." He went on to explain that the credit's purpose is satisfied while "disputes wend their way towards resolution with money in the beneficiary's pocket. . . ." Cases from a variety of jurisdictions take pains to differentiate independent undertakings, sometimes called "guarantees" or "demand guarantees" on the one hand and suretyship obligations on the other, applying letter of credit law to the former only, usually in cases where the principal obligor is attempting to stop payment of the independent undertaking before the parties resolve underlying contract disputes. UN—CITRAL has fashioned distinct rules for these "guarantees" but only if they are independent of the executory obligations they secure. Commentators worldwide, moreover, are in general agreement that letters of credit must be treated in law as independent undertakings that are not subject to disputes in the underlying transaction.

CONCLUSION

It is not enough that the Fifth Circuit issued its *Express Blower* opinion *per curiam* and directed that it not be published. The court's dictum is bold and easily accessible in the databases. It is, however, boldly incorrect. It is not supported by commercial practices or policies, nor does it find support in rulings by other circuits that have considered the issues with care. In the future, lest *Express Blower's* loose assertion sink commercial ships, one must hope that lawyers and courts will give the ruling the respect it deserves by ignoring it as ill-considered dictum.

See John F. Dolan, *Letter of Credit Undertakings and Suretyship Contracts: Did the Fifth Circuit Slip in Express Blower, Inc. v. Earthcare, LLC?* 129 BANKING L. J. 291, 296–297 (April 2012) (footnotes omitted); *see also Express Blower, Inc. v. Earthcare LLC*, 410 Fed. Appx. 742 (5th Cir. 2010) (*per curiam*) (as revised Feb. 4, 2011); Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. Chi. L. Rev. 218, 223–226 (1985) ("The standby letter of credit can also

(Text continued on page 223)

be compared with another device that is commonly used to allocate risks among parties in commercial transactions—the performance bond. Both devices are used to protect a party against the risk of nonperformance of another party's contractual obligations. Nevertheless, standby letters of credit differ in several important respects from performance bonds. A performance bond is issued by a surety company, a private firm, or an individual, rather than by a bank, and guarantees a buyer of goods or services that the seller (the principal) will perform. A surety's obligation is secondary to that of the principal, however, and the surety becomes liable only when the principal has in fact defaulted on its obligation. Thus, unlike the issuer of a standby letter of credit, the surety does not pay the buyer automatically upon the buyer's assertion that the seller has not performed: it may first investigate the truth of the assertion. If the surety determines that the seller has fulfilled the contract, then it may refuse to pay the buyer. The surety may also assert any defenses against the buyer that would be available to the principal. Furthermore, the surety retains the option of actively intervening to ensure performance either by demanding that the seller remedy the defect in its performance or by completing the contract itself. The standby letter of credit differs from the performance bond in the way in which it protects a buyer against the risk of nonperformance. The standby letter of credit allows the beneficiary to recover damages simply by asserting that the customer has defaulted on the contract; except where the fraud in the transaction exception applies, the issuer is not permitted to refuse payment based either on its belief that the beneficiary's assertion is false or on the existence of any defenses that the customer may have on the underlying contract. For a number of reasons, this basic difference between the standby letter of credit and the performance bond makes the standby letter of credit potentially more useful to the beneficiary than the performance bond. First, the beneficiary benefits from the greater 'automaticity and brevity' of payment under the standby letter of credit: the bank may inspect only the tendered documents, and payment will not be delayed by the bank's investigation of the underlying contract. Second, the standby letter of credit is more flexible than the performance bond because it can be used in a wider variety of transactions. Third, the administrative expenses involved with a standby letter of credit may be lower than those involved with a performance bond, thus reducing the cost of a standby letter of credit; because the bank is only responsible for scrutinizing the documents presented upon demand, and because the bank will often already be very familiar with the customer's creditworthiness and with the underlying transaction, it will often be able to avoid incurring the additional or duplicative expenses of investigating and monitoring the underlying contract. Moreover, the standby letter of credit has the advantage that the bank incurs a much lower risk of becoming embroiled in litigation with the beneficiary than does a surety. Finally, the standby letter of credit allows parties to take advantage of the financial soundness of banking institutions; while banks are free to issue standby letters of credit, they are generally forbidden from issuing performance bonds. While the standby letter of credit offers a number of potential advantages over a performance bond, it also increases the risks to the bank and customer. Unlike a performance bond, a standby letter of credit gives the issuing bank no control over the underlying contract and no right to refuse payment based on its opinion that the customer has properly performed. In view of the relative positions of the beneficiary, the seller, and the issuing bank, the standby letter of credit is more analogous to a cash deposit left with the beneficiary than it is to the traditional letter of credit or to the performance bond. Because the beneficiary generates all the documents necessary to obtain payment, he has the power to appropriate the funds represented by the standby letter of credit at any time. Although the customer may sometimes have payment enjoined when fraud is present, he is obligated to reimburse the bank if the bank has made a payment in good faith, even

Also, the U.S. Securities and Exchange Commission ("SEC") issued an "Investor Alert" to warn investors about fraudulent investment schemes involving standby letters of credit. Specifically, it noted:

> Promoters of prime bank programs often claim that investors' funds will be used to buy and trade supposed prime bank instruments, and that investors will receive guaranteed, high investment returns with little or no risk. Promoters try to make the schemes sound legitimate by using complex, sophisticated, and official-sounding terms. These may include: debenture, standby letter of credit, bank guarantee, prime world bank financial instrument, private funding project, offshore trade or trading program, trading platform, trading facility, trade slot, high-yield trading or roll program, guaranteed bank note, or some variation.[25]

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upon a fraudulent demand. And because many standby letters of credit contain no provision requiring notice to the customer before the beneficiary receives payment, the injunction remedy that theoretically is available under the fraud in the transaction exception would often prove useless. Even though the standby letter of credit is functionally equivalent to a cash deposit, it differs from a cash deposit because the customer does not have to part with its own funds until payment is made and it is forced to reimburse the issuing bank. Because the cash-flow burden might otherwise be prohibitive, this is a great advantage to a party who enters into a large number of transactions simultaneously. Moreover, the beneficiary is satisfied; while it does not actually possess the funds, as it would if a cash deposit were used, it is protected by the credit of a financial institution") (footnotes omitted); Herbert A. Getz, Comment*, Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases,* 21 Harv. Int'l L.J. 189, 193 & n.27 (1980) ("Since January, 1979, United States companies have initiated more than twenty separate actions seeking to enjoin payment on international standby letters of credit associated with Iranian government contracts. . . . [I]t has been used since World War II in international transactions in much the same manner as a surety bond. . . . Banks typically issue standby credits at a price of one percent of face value or less, while surety bonds cost two percent and up") (footnotes omitted).

[25] *See* https://www.sec.gov/oiea/investor-alerts-bulletins/ia_primebankscam.html ("Investor Alert: 'Prime Bank' Investments Are Scams"); *see also id.* ("In *SEC v Butts, et al.* [https://www.sec.gov/news/press-release/2013-175], the SEC charged numerous individuals and entities for allegedly conducting a prime bank scheme. Defendants allegedly told investors that an initial investment of $60,000-$90,000 would be used to purchase Standby Letters of Credit that would be invested in a trading program yielding an immediate return of more than $8 million within 15 to 45 business days, to be followed by earnings of approximately 14% per week. Defendants allegedly assured investors that an attorney would hold the investors' funds in escrow until the bank instruments were obtained. According to the SEC's complaint, investors were lured through the Internet, telephone, and personal contact with promises of extraordinary profits. The SEC alleges that the purported international trading program did not exist and that the defendants used the investors' money to pay their own personal expenses such as travel and gambling"); *United States v. Taylor*, No. 17-cr-00191-JST-1 (N.D. Cal. Oct. 12, 2018) ("The indictment alleges that Taylor and his co-defendants . . . were involved in a scheme to market and sell

CONCLUSION

No one should deny the opportunity for American banks and other financial institutions to make a profit and serve their customers—and compete with their counterparts abroad—as long as they act responsibly and legally, and their solvency and stability are not put at risk.

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fictitious financial instruments, including 'Proof of Funds Statements' and 'Standby Letters of Credit' ('SLOCs')"); *In re Trustees of Conneaut Lake Park, Inc.*, 592 B.R. 64, 71 (Bkrtcy.W.D.Pa. Sept. 28, 2018) (U.S. Bankruptcy Court for the Western District of Pennsylvania noted that ""the Third Circuit in *Tudor Dev. Grp., Inc. v. United States Fidelity & Guar. Co.*, 968 F.2d 357 (3d Cir. 1992), found that, in contrast to a guarantor of a debt, a bank which issued standby letters of credit in connection with a construction project cannot "accede to the rights of its customer" when it pays out on the standby letters of credit. The court reasoned that the liability the bank satisfied in making the payment was its own—for which it was primarily liable—as the bank was contractually obligated to make the payment. As noted by the Third Circuit: "[T]he key distinction between letters of credit and guarantees is that the issuer's obligation under a letter of credit is primary whereas a guarantor's obligation is secondary—the guarantor is *only* obligated to pay if the principal defaults on the debt the principal owes. In contrast, while the issuing bank in the letter of credit situation may be secondarily liable in a temporal sense, since its obligation to pay does not arise until after its customer fails to satisfy some obligation, it is satisfying its own absolute and primary obligation to make payment rather than satisfying an obligation of its customer. Having paid its own debt, as it has contractually undertaken to do, the issuer "cannot then step into the shoes of the creditor to seek subrogation, reimbursement or contribution from the [customer]. The only exception would be where the parties reach an agreement to the contrary." *In re Kaiser Steel Corp.*, 89 B.R. 150, 153 (Bankr. D.Colo. 1988)." *Tudor Dev. Grp., Inc.*, at 362""; *In re Circuit City Stores, Inc.*, 591 B.R. 289, 291 (Bkrtcy.E.D.Va. Aug. 27, 2018) (U.S. Bankruptcy Court for the Eastern District of Virginia noted that "[a]t the time of the bankruptcy filing and for a short period thereafter, Circuit City conducted business as a national retailer of consumer electronics with operations across the United States, including the state of California. For its operations in the state of California, the Debtors elected to self-insure their workers' compensation obligations. To secure the payment of any such claims that arose in California, the Debtors posted an irrevocable standby letter of credit issued by Bank of America N.A. in the amount of $14,119,256 (the 'Letter of Credit'). The Letter of Credit remained in place after the Petition Date. In connection with their decision to self-insure workers' compensation claims, the Debtors also obtained 'excess insurance policies' from Old Republic Insurance Company ('ORIC'). Under the excess insurance policies, the Debtors were responsible for the first $300,000.00 owed on any particular claim (the 'Retention'), and ORIC insured Circuit City for any 'loss' in excess thereof. To secure the Debtors' obligations under the excess insurance policies, the Debtors posted various letters of credit with ORIC. ORIC continues to use those letters of credit to satisfy its obligations as excess insurance carrier") (footnotes omitted); *Chase v. Merson*, No. 2:18-cv-00165-NT (D. Maine July 15, 2018) ("The plaintiff filed the instant complaint on April 19, 2018, alleging that 10 named defendants fraudulently induced him to invest $500,000 in standby letters of credit by promising a $10 million return in seven to 12 days on every $250,000 invested"); *Citizens State Bank of Lometa v. F.D.I.C.*, 946 F.2d 408, 414–416 (5th Cir. 1991) (The Court held that standby letters were provable against FDIC even though beneficiary did not attempt to draw on them until after bank was declared insolvent).

One of the great unheralded risks to the U.S. and global economies for many decades has been that there may be panicking in the markets, and the Fed and other central banks would be unable to control it. In the process, American and foreign investors might seek to liquidate their holdings in funds and other relatively-illiquid investments, and may be unable to do so—at least in an orderly fashion—and a historical liquidity crisis might ensue.

The chaos produced may mirror that involving standby letters and other guaranties, which might be drawn down at effectively the same time, thereby exacerbating panic selling and liquidations. Similar "perfect storms" have happened with some regularity in the past; and the risk of this one looms evermore, producing images of earlier panics and crashes in history.[26]

Above all else, the safety and soundness of U.S. financial institutions must be assured and preserved.[27] American and foreign regulators and policymakers are not "miracle workers," and at some time in the future they may be unable to stem the tide, and an epic panic and crash might occur, like those in the past. And yes, Congress, the Fed and other central banks may be helpless if this happens.

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[26] *See, e.g.*, https://en.wikipedia.org/wiki/Great_Depression ("Great Depression"); https://en.wikipedia.org/wiki/Wall_Street_Crash_of_1929 ("Wall Street Crash of 1929"); https://en.wikipedia.org/wiki/Panic_of_1893 ("Panic of 1893"); https://en.wikipedia.org/wiki/Black_Friday_(1869) ("Black Friday (1869"); https://en.wikipedia.org/wiki/List_of_stock_market_crashes_and_bear_markets ("List of stock market crashes and bear markets"); https://en.wikipedia.org/wiki/List_of_banking_crises ("List of banking crises").

[27] *See, e.g.*, Paul R. Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 Tul. L. Rev. 314, 328 (1978–1979) ("Standby letters of credit that serve as guaranties of otherwise unsupportable corporate obligations have become an increasingly dangerous banking practice. Since the failure of USNB in 1973, the banks and the regulatory agencies have been wrestling with Congress over how to control the issuance of these standbys").