The Use of Standby Letters of Credit in Public and Affordable Housing Projects

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Introduction

The nature of construction projects is such that significant money must be spent and liabilities incurred prior to the completion and delivery of a final product. Because of the uncertainties involved in this process, prudent developers and their lenders require some measure of assurance from general contractors that the subcontractors will be paid and the work will be performed according to the construction documents. These assurances typically take the form of payment and performance bonds, more generally called "surety bonds."

Because surety companies provide surety bonds largely on the basis of demonstrated experience, many smaller contractors have difficulty qualifying for and obtaining adequate surety bonds. Public housing authorities (PHAs) and affordable housing developers often specifically seek to employ local or emerging contractors, who often tend to be smaller firms without significant demonstrated experience. Often, those contractors who are unable to produce a surety bond ask to instead provide something called a standby letter of credit. "Standbys," as they are called, are fairly commonly used in a variety of commercial transactions in place of deposits, guarantees, or other future assurances.[1]

This article details the differences between standby letters of credit and the classic surety bonds and identifies concerns particular to the use of standbys in lieu of surety bonds in the public and affordable housing context. Even assuming that letters of credit are desirable from the developer's standpoint, public and affordable housing developers must address concerns and requirements from the various entities involved in public and affordable housing, including the U.S. Department of Housing and Urban Development (HUD), state housing agencies, city governments, and tax credit syndicators. Finally, there are a variety of laws and rules that can be applied to standbys, according to the particular language of the letter of credit itself.[2] Although these rules overlap significantly, it is important for a developer accepting this form of security to be aware of the differences.

What Is a Surety Bond?

A surety bond is a three-party agreement whereby the surety company will pay the beneficiary (or obligee) if a specified third party fails to per-

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form some other, primary obligation. There are numerous types of surety bonds used in commercial construction, but this paper focuses on two: the payment bond and the performance bond. The payment bond serves as security that funds advanced to the contractor by the owner will be used to pay for labor and materials provided by various subcontractors. The performance bond provides security that the contractor will perform and complete the work in accordance with the construction documents. Performance bonds protect the owner directly by ensuring available funds to complete the original contract, while payment bonds are provided largely for the benefit of subcontractors.

Although surety bonds are ultimately generated by insurance companies and their effect is similar to obtaining insurance against a loss, they should not be confused with traditional insurance. Most importantly, a surety bond is obtained by the contractor for the benefit of the developer and involves three parties rather than two. Because the surety will seek reimbursement from the contractor for any loss, the surety has obligations to both the contractor and the developer. Obtaining a surety bond requires a rigorous prequalification process whereby the contractor exposes much more detailed information to the surety than she would likely be willing to share with a developer (assuming such developer even had sufficient knowledge and experience with which to adequately assess the contractor's competence and ability). As a result, even private developers with no external or regulatory requirements typically still require a bond as independent and reliable evidence that a particular contractor is capable of completing a particular job.

The surety is subrogated to all the rights, claims, and defenses of the contractor; however, the surety is only secondarily liable for the actions of the contractor. This means that the contractor must have failed to fulfill its contractual obligations before the surety is liable. As a result, before paying on a bond, the surety must conduct an investigation to determine if a default has been properly declared by the developer. Even assuming that the surety ultimately agrees to its liability, the process of coming to that agreement can delay construction considerably.[3] If the surety ultimately decides that it is not liable, then the developer will have to bring a lawsuit in order to compel payment or performance. Meanwhile, adequate funds to complete the project may be unavailable.

What Is a Standby Letter of Credit?

Rather than a three-party agreement, the letter of credit is an independent agreement by the issuer (bank) to pay a specified amount to the beneficiary (in this case, the project developer) upon the presentation of certain documents. Letters of credit were originally developed to facilitate international trade. Because the buyer and seller were wholly unrelated entities in distant locations, often with different legal systems, neither party was willing to send the other either money or goods first without some reliable assurance of payment. A letter of credit provides such assurance. The pur-

pose of the letter of credit is to substitute the bank's established credit for the credit of the bank's customer (the contractor, or, more generally, the "applicant"). What are now called commercial letters of credit both ensure and facilitate payment between two distant parties. Once the seller ships goods, she presents the official bill of lading and any other specified documents to receive prompt payment from the bank. The bank then seeks reimbursement from the buyer.

Letters of credit have subsequently been used for similar purposes in numerous other contexts where substantial funds must be advanced prior to the completion and performance of specified services, e.g., commercial letters of credit used in international trade.[4] These commercial letters of credit differ in few but important ways from standbys.[5] One significant difference is that the issuer of a commercial letter of credit expects to pay on the letter and be reimbursed by the applicant in the ordinary course of business, whereas the issuer of a standby will typically only pay in the event of a default by its customer/applicant. As a result, payment on a commercial letter of credit depends on proof of performance, whereas payment on a standby letter of credit depends on proof of nonperformance. Nonperformance often means that the applicant contractor is bankrupt and the issuing bank may have difficulty receiving reimbursement. This distinction is one reason that it is often difficult to apply to standbys rules developed primarily for commercial letters of credit (discussed *infra*).

Perhaps the most important characteristic of any letter of credit is its independence from the transaction or obligation it is intended to support. A letter of credit is typically only issued following two other separate agreements: 1) the underlying construction contract between the developer and the contractor; and 2) an agreement between the issuing bank and its customer, the contractor, whereby the bank agrees to issue a letter of credit and the contractor agrees to reimburse the bank for any payment on the letter. The letter of credit that is ultimately issued pursuant to this arrangement, however, is an independent agreement between the issuing bank and the developer, and payment by the bank is dependent solely on the presentation of specified documents by the developer. As a result, unlike with surety bonds, the bank has no obligation to investigate the underlying performance of the contractor.

Qualifying Processes

If standby letters of credit are essentially equivalent to surety bonds, it seems reasonable to ask why some contractors qualify for one and not the other. The answer to this question is complex and varies by individual contractor and by the particular construction projects themselves. There are, however, some important general differences between the qualifying processes that can affect the result.

First, insurance companies (through surety companies) award surety bonds, but banks typically issue letters of credit.[6] Both entities apply a rigorous review process, including the financial health and previous track

record of the contractor, experience with the particular contract requirements and proper equipment, and good references and overall reputation. Although a contractor just starting out may have little track record of performance, that contractor is likely to have a preexisting and wider relationship with a bank, including other outstanding loans, significant credit history, cash collateral, and perhaps even individual personal assets. Thus, a bank may have more confidence than a surety in an existing client's ability to either complete the project or to reimburse the bank.

Second, both sureties and banks look into the feasibility of the specific project being applied for as well. Particularly regarding mixed-income and affordable housing projects, the margin for error is already significantly narrower than on a standard private construction project. Additionally, there may be heightened concerns where the contractor seeking a bond is also a part of the development entity, such as often happens in the affordable housing context. Although these concerns should theoretically affect banks and sureties equally, banks are more likely to focus on the financial aspects of the letter of credit (i.e., the ability of the contractor to provide reimbursement), while sureties often focus more on the degree of risk in the project itself. Furthermore, banks subject to the Community Reinvestment Act (CRA) may actually be required to fund a certain number of projects and contractors in particular communities that otherwise would exhibit an unacceptable level of risk.

Perhaps the most important reason that a contractor might qualify for a standby and not a surety bond, however, is that the amount of coverage required under the two instruments can differ substantially. Construction loan funds are only disbursed in partial draws over the course of construction, and each draw typically requires that the contractor provide certifications by the subcontractors that they received payment from the previous draw. As a result, the potential loss from a contractor's nonpayment is only the approximate amount of one such draw rather than the entire cost of construction. Loss from nonperformance can be substantial, but there are numerous additional safeguards to ensure that the contractor is adding value in rough proportion to the amount being paid out.[7] Despite the limited nature of the potential loss, surety bonds are often required to cover an amount equal to 100 percent of the construction cost. Acceptable letters of credit, however, often cover only 25 percent of the contract price.[8]

Much of the regulatory language requiring bonds uses the phrase *penal sum*, and this phrase may imply that the 100 percent requirement is seen in part as a penalty for default, not just coverage for loss.[9] Also, because the costs of calling a bond may include the costs of delay and potential litigation, the different percentages of coverage required of standbys and surety bonds may also be a reflection of the ease and speed of drawing on letters of credit.

A bond covering 100 percent of construction costs would require four times as much collateral from a small or emerging contractor as a letter of credit covering 25 percent. Additionally, in part because of the more limited

liability that banks face when paying on standbys, bonds are often more expensive than standbys even for the same face amount. According to the Surety Information Office, surety bonds cost between 0.5 to 2.0 percent of face value, while a letter of credit typically costs roughly 1.0 percent of the amount covered.[10] Thus, a 100 percent bond on a $4 million project would cost between $20,000 and $80,000, while a 25 percent standby would cost the contractor just $10,000.

The surety industry has, however, developed its own program to help small and emerging contractors, who would not otherwise meet the sureties' minimum standards, qualify for bonds. The Surety Bond Guarantee (SBG) Program is administered by the Small Business Association (SBA) and provides a guarantee agreement to the surety company of up to 90 percent of the amount of the bond. Although the SBG Program only applies to projects under $2 million, smaller contractors on affordable housing projects of that size may be unaware of this program and so may actually qualify for a surety bond even though they are urging a developer to accept a letter of credit.[11]

Benefits and Burdens of Substitution

The basic purpose of a letter of credit is to provide an assurance of payment.[12] As one author noted, "The primary reason letters of credit are so widely used in sales transactions is that they provide a quick, convenient and sure method of payment."[13] Those benefits—speed, convenience, and certainty—exist in the use of letters of credit in the construction context as well, particularly as compared to surety bonds.

The standby is an agreement between an issuing bank and a beneficiary developer that evidences an obligation independent of the performance of the contract it is intended to support. This independence is the primary advantage of letters of credit over other dependent obligations and is emphasized in Article 5 of the Uniform Commercial Code (U.C.C.) governing letters of credit: "Only staunch recognition of [the independence principle] by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit."[14] One of the main benefits of this independence for the developer is that payment is due from the issuer upon presentation of the documents specified in the letter of credit. The issuer is obliged simply to ensure that it has been provided with the appropriate documents specified in the letter of credit, at which point it must disburse payment and seek reimbursement from the applicant. As a result, payment is quick and sure.

If there is a dispute about the underlying construction contract, the applicant contractor still has the right and ability to litigate with the developer; but the burden of litigation is on the contractor rather than on the developer. With a surety bond, the bonding company usually withholds payment until the contractor's default is determined, thus often requiring the owner to sue to recover any money. In contrast, a letter of credit requires the bank to pay the owner upon request; and if there is any dispute, the

contractor must initiate a lawsuit to recover the money. In the meantime, the project can be completed according to the original schedule. Although litigation can never be described as convenient, the ability to move forward with a project that may otherwise be in dispute is an advantage of standby letters of credit.

The sacrifice of speed and convenience following default on surety bonds, however, is made up for in the speed and convenience of avoiding default altogether. The surety's prequalification review of the contractor is an extremely rigorous and detailed assessment, conducted by professionals who specialize in assessing the skills and resources necessary to complete construction projects. Additionally, in order to avoid paying out on a bond in the first place, a surety will often require updates, however minimal, from both the contractor and the developer on the progress of the project.[15] In extreme circumstances, a surety may even be willing to advance funds or expertise to the contractor to enable her to weather cash flow or other difficulties and to avoid default entirely.[16]

In the end, what the developer really wants is performance under the contract, not cash to go out and hire another contractor. With performance bonds at least, the surety will often step in and complete the project rather than pay out under the bond. This is often the case because, as noted earlier, the contractor is likely to be bankrupt and there is often the potential for the surety to complete the project with minimal losses. A bank that has issued a letter of credit, however, simply has the duty to pay under the letter. Whether performance by a surety is better than payment by a bank will still depend on the ability to convince the surety that it is liable in the first place.

Much of this paper is about technical differences in surety bonds and standbys and logistics about how to actually use a standby letter of credit. But the substantive difference underlying the initial decision of whether to even consider allowing a standby to substitute for a surety bond is that surety bonds are geared toward avoiding default whereas standbys will cover losses in the event of a default. If a contractor is not able to qualify for a bond on a particular project, that fact should be a significant red flag for any developer. However, if a particular developer has a secondary policy goal of providing start-up opportunities for small or emerging contractors, then hiring contractors who do not otherwise qualify for a large surety bond may be part of that goal.[17] If so, then accepting a letter of credit in lieu of a surety bond should cover any potential losses and ensure that the project can be completed while achieving important secondary goals as well.

Who Decides, and on What Basis?

Public and affordable housing projects often involve numerous funding entities with complex requirements that attach to such funding, including standard language requiring the contractor to provide surety bonds. On projects funded by low-income housing tax credits, for example, the in-

vestors' benefits from the project, i.e., tax credits, are contingent on the date the project is completed and placed in service. As a result, investors are particularly concerned about the contractor's ability to pay subcontractors and to timely perform construction, and so the tax credit syndicators typically require 100 percent surety bonds. For this same reason (that the tax credits are subject to recapture if the project is never completed), however, neither the IRS nor the state agency awarding the credits impose any independent bonding requirements.

Tax credit projects often also rely on funds provided by a local city agency, often through the Community Development Block Grant (CDBG) Program, or by a state agency, such as the Michigan State Housing Development Agency (MSHDA) Direct Lending Program. These funds typically carry their own independent requirements for surety bonds but often have specific authority to allow for exceptions.[18] As the funds provided by these programs are often substantial but subordinate to the overall funding, any letter of credit that is acceptable to the primary funding agency will likely be sufficient to satisfy these agencies.[19]

On public housing projects, funding for new construction is typically provided by HUD either as Capital Funds or through HOPE VI revitalization grants. HUD regulations require that PHAs spending Capital Funds receive surety bonds from the contractor but also allow for alternatives to surety bonds as long as HUD makes a determination that HUD's interest is "adequately protected."[20] As for what it means to be "adequately protected," HUD's *Instructions to Bidders for Contracts* provides an initial option for the contracting officer to accept a number of different assurances of completion, including "a 25 percent irrevocable letter of credit."[21] However, this publication simply establishes a general standard, and HUD could accept a letter of credit for even less than 25 percent if the PHA risk in a particular project were minimized, such as where the PHA does not own the development and where a private lender has the primary risk. This situation is the case in many new construction deals involving Low Income Housing Tax Credits under HUD's "mixed-finance" method.

In addition to HUD requirements, however, PHAs are either public or quasi-public city agencies and thus often subject to various state laws requiring surety bonds for public construction. Such laws vary somewhat but are generally identical to a similar federal requirement called the Miller Act.[22] As described later, there are specific provisions for the use of letters of credit in lieu of Miller Act bonds, though particular requirements may vary somewhat by state.[23]

Overall, a public agency is likely to be willing and able to accept any assurance of payment and performance that the primary market-rate lender is willing to accept. It is, in the end, the bank's money that is most at risk. Fortunately, letters of credit are bank-drafted instruments, and the specific rules governing them are largely bank-drafted rules rather than legislative or judicial decisions.[24] Most construction lenders will be familiar enough with letters of credit that they will readily accept those that meet some

basic requirements. However, this ultimate acceptance does not mean that particular federal or state agencies will not still require some explanation or documentation or that the lawyers for the development entities themselves need not be familiar with the differences between standby letters of credit and surety bonds and the rules that govern each.

Miller Act Bonding Requirements

Construction projects undertaken by federal agencies are subject to the Miller Act.[25] The Miller Act expressly requires general contractors to provide payment and performance bonds as a condition of working on a project. This protection is especially important to subcontractors, who are usually protected by the ability to place a mechanics' lien on a property but for whom such liens are precluded against public property.[26] Although the Miller Act only applies to construction undertaken by federal agencies, most states have bonding requirements for public projects that may apply to PHAs and occasionally to other projects with significant public funding. These state laws typically mirror the Miller Act and are thus called "little Miller Acts."[27] As such, a discussion of the requirements of the Miller Act should cover the primary issues in satisfying state requirements as well.

In 1991, the U.S. Office of Federal Procurement Policy (OFPP) issued a letter ruling explicitly allowing federal agencies to use letters of credit in lieu of surety bonds required by the Miller Act.[28] This authorization by OFPP was made for the purpose of increasing the competitiveness of small businesses for government contracts.[29] Ten years later, that position was codified in the Federal Acquisition Regulations (FAR) at 48 C.F.R. 52.228-14. The FAR require that a letter of credit used in lieu of a payment and performance bond be irrevocable; requires the presentation of no document other than a written demand for payment; and must be issued by an acceptable, federally insured financial institution. Additionally, the FAR specifically references the use of letters of credit described therein for projects subject to the Miller Act.[30] Again, the FAR does not apply to PHAs, but its language is illustrative of how to address the sorts of concerns raised in the various little Miller Acts,[31] and excerpts are thus reproduced in footnotes where appropriate.

Governing Law Regarding Standby Letters of Credit

Although the standby letter of credit is often described as an independent contract between the issuer and the beneficiary, it is technically not a contract at all and so not properly subject to laws governing contracts.[32] In the United States, the use of standby letters of credit is instead governed by individual state laws that largely track Article 5 of the U.C.C. (Article 5). Article 5 was revised in 1995 to address weaknesses in the prior version and to account for decades of changes and development in letter of credit law, including the emergence of the standby letter of credit. All U.S. states have adopted these revised changes, though occasionally with relatively minor idiosyncratic alterations.[33]

Article 5, however, simply provides a general outline and structure for the use of letters of credit and by its own terms is not intended to be comprehensive.[34] Specifically, when Article 5 was revised, the authors expressly allowed for the incorporation of other rules by reference, in particular, the Uniform Custom and Practice for Documentary Credits (UCP), published by the International Chamber of Commerce (ICC).[35] Article 5 specifies that, but for a few reserved exceptions,[36] the rules are considered to be "acceptable contractual modifications" to Article 5 where they conflict with Article 5. Where specifically incorporated rules are silent, however, Article 5 continues to operate in the background.[37]

The UCP was written specifically for commercial letters of credit and only applies to standby letters "to the extent to which they may be applicable."[38] Given the small but important distinctions between commercial and standby letters of credit, there are a number of provisions in the UCP that are irrelevant or perhaps even harmful to parties involved in a standby transaction.[39] As a result, in 1998 (and following the 1995 revisions to Article 5), the ICC published a separate set of rules specifically for standby letters of credit, called the International Standby Practices (ISP98).[40] In particular, because standbys are generally used in default situations, the ISP98 is more detailed and specific than the UCP. In publishing the ISP98, the ICC has demonstrated its intent that the ISP98 replaces the UCP as the general rules applied to standby letters of credit.[41]

Standby letters of credit used in lieu of surety bonds are among the least complicated standbys, typically requiring only the presentation of a draft for payment. This simplicity is one of their primary benefits. That said, the advantages of using the ISP98 are more significant the more complex the standby.[42] Many banks issuing standbys for construction continue to reference the UCP, either out of habit or out of unwillingness to fix something that is not obviously broken.[43] This paper references the UCP as the most common rules applied to standbys but also takes care to note important differences in the ISP98 rules where they exist.

Drafting a Standby Letter of Credit

As they are intended to be simple instruments, most standby letters of credit used to substitute for surety bonds will contain fairly standard clauses and language provided by the issuing bank.[44] Whether the standby is made subject to the UCP or to the ISP98 will largely depend on the format of the issuing bank. Although the standby will ultimately have to be approved by the primary lender on any project, the developer's counsel must understand the instrument as well and should be aware of a number of basic elements, described below.

The Named Beneficiary

Perhaps the most obvious difference between letters of credit and surety bonds is the named beneficiary. Surety bonds are usually dual obligee, meaning that there are two beneficiaries: typically, the primary market-rate

lender and the development entity. This dual obligee status reflects the importance the primary lender places on ensuring payment and performance, as mentioned above. The unique rules regarding letters of credit, however, make a similar dual obligee (or dual beneficiary) status inconvenient for the beneficiaries themselves. If a letter of credit has two named beneficiaries, they must typically both agree to and provide the proper documentation for a draw, occasionally in a hectic situation where the letter of credit may be about to expire.[45] Any delay resulting from confusion or even conflict between the beneficiaries may cause the letter of credit to expire before being properly drawn. As a result, letters of credit typically have just one named beneficiary, with concerns about how to disperse or manage the funds addressed in a separate intercreditor agreement.[46] For public and affordable housing projects, the market-rate lender, rather than the development entity, should be the sole beneficiary.[47]

Perhaps it is enough to say that the primary lender will likely refuse to accept any standby letter of credit in which it is not the named beneficiary. However, it is important to note that a default on the part of the contractor may be evidence of mismanagement or lack of oversight by the developer itself, and in such a case it would be imprudent to put the developer in greater control of the project's success. Further complicating the possibility of naming the developer as the beneficiary, many affordable housing and mixed-income developments involve the general contractor as a partner in the development entity as well. As a result, most officials at the public funding agencies whose agreement is required to accept letters of credit should have no problem with the primary lender being the sole beneficiary and may even require it.

One advantage of having the market-rate lender be the beneficiary is that letters of credit are bank-issued documents, and both the UCP and ISP98 rules are largely bank-drafted rules codifying standard practices rather than legislative pronouncements. Because inattention to many of the otherwise simple requirements of a letter of credit described below can result in a total forfeiture of the letter of credit, forfeiture would pose a significantly greater risk if the beneficiary were an entity unfamiliar with letters of credit. That said, because the main reasons to accept a letter of credit in lieu of surety bonds deal primarily with policy goals of the developer or other funding entities, it is important that those entities understand the basic structure they are asking the lending bank to accept.

Under letters of credit, subcontractors lack the independent protection they often have under standard surety bonds.[48] This lack of protection is a particular problem because most of the little Miller Acts requiring public agencies to hire bonded contractors do so in large part for the protection of subcontractors.[49] As a solution, one commentator (writing in 1993, prior to the revisions to both the UCP and the U.C.C., as well as the issuance of the ISP98) suggested naming "subcontractors, suppliers and others protected under the Miller Act" as additional beneficiaries in the letter of credit.[50] This solution may be worse than the original problem, however,

because of the problems with multiple beneficiaries described above. Regulations applicable to federal construction projects typically deal with this problem by requiring that the letter of credit be freely assignable by the government agency or owner, without charge.[51] The UCP specifies that the proceeds of a letter of credit are assignable, but not the right to demand payment on the credit itself.[52] Similarly, the ISP98 allows an assignment if the issuer acknowledges such but expressly confers no rights to the assignee under the credit.[53] However, the U.C.C. provision regarding consent to an assignment of proceeds is one that may not be altered by incorporation of other rules, such as the UCP or the ISP98. This provision says that if presentation of the letter of credit itself is a condition to honor, then the issuer may not unreasonably withhold its consent to such an assignment if the assignee produces the original letter.[54] Regardless, it is possible and may be more advantageous to address the interests of subcontractors through a general intercreditor or escrow agreement.

Expiration and Extension

As with bonds, letters of credit expire.[55] If the letter of credit expires before the beneficiary fully satisfies the documentary terms, then the bank will be relieved of any obligation to pay.[56] Because letters of credit are document-driven rather than fact-driven, courts (and thus banks) strictly enforce the terms as stated.[57] This strict enforcement means that the issuing bank will refuse to honor a letter of credit if the beneficiary has presented prior to expiration documents that are incomplete or imperfect.[58] Although the possibility of losing the entire benefit of the credit is significant, it is important to remember that the beneficiary on the letter of credit is the primary lender, and the lender is the party most knowledgeable about monitoring expiration and requesting any extensions.

The UCP and the ISP98 both require that parties to a letter of credit expressly state a specified expiry date,[59] but neither provides any default rules in the absence of such a statement.[60] Under Article 5, however, the expiration date of the letter of credit is limited regardless of the text of the letter itself. If no expiration date is mentioned at all, letters of credit expire one year from issuance. As most construction projects will take more than one year, it is extremely important to ensure that an appropriate date of expiration is clearly written into the terms of the letter of credit. If that date approaches and the project is not yet complete, negotiations to procure a new letter of credit should begin early enough to ensure that at no point will the project be unsecured.

Article 5 also has a prohibition against perpetual letters of credit,[61] which are expressly excepted from the general rule that the provisions of Article 5 can be varied by agreement.[62] Under Article 5, a letter of credit that is stated to be perpetual by its own terms expires five years after its date of issuance. As such, any developer accepting a standby will need to insist on clear provisions for extension. Many standbys provide for automatic extension if the issuer fails to timely notify the beneficiary otherwise, often

in writing.[63] Although extension clauses are often intended to be perpetual (i.e., extended annually until otherwise stated), other language in the standby may be used to limit these extensions.[64]

Although the agencies involved in approving the use of the letter of credit in the first place will likely demand extensions at least through the expected date of final payment on the construction contract, an issuer may want to limit the possibility for automatic extension of a letter of credit.[65] If such is the case and a letter of credit is about to expire before the project has actually been completed and final debts paid, the beneficiary to a letter of credit may give notice to the issuing bank to extend or pay on the letter. Such a presentation is called "extend or pay" and is expressly described in the ISP98.[66] Those rules provide that such a notice qualifies as both a presentation and a demand for payment, even though this demand is necessarily in a different form than otherwise required to draw on the letter of credit. If the issuer and applicant agree to extend the letter of credit, then the demand for payment is deemed to have been retracted. There is no similar extend-or-pay provision in the UCP, and so a letter subject to the UCP should clearly state the terms for receiving an extension. Conversely, if the underlying construction contract provides for a default if the contractor does not provide for an extension or replacement credit within a specified time period, then the beneficiary developer will in effect have an extend-or-pay option.

Documentary Conditions

Letters of credit were initially developed to ensure and facilitate payment in a wide variety of industries, often involving different languages and customs, whereby the issuing bank could not regularly be in a position to determine the sufficiency of the underlying transaction or the relevant standard practices of various industries. As a result, letters of credit differ significantly from surety bonds in that the parties deal strictly in documents rather than looking to the performance of the underlying construction contract.[67] As standbys used in construction are meant to be simple, the only documents that are typically required in order to effectuate a draw are the original letter of credit itself and what is called a sight draft, i.e., essentially just a statement to the effect that the letter is being presented to a particular bank for payment, often including language stating that payment is due because a default event has occurred.[68] Under the UCP and the ISP98, any language referencing the underlying transaction or contract as a condition for honoring a letter of credit is expressly to be ignored.[69]

The standard described in Article 5 requires documentation that "appears on its face strictly to comply" with the terms of the credit.[70] Similarly, the UCP requires issuing banks to determine "whether or not [the documents] appear, on their face, to be in compliance" with the terms of the credit.[71] Finally, the ISP98 requires issuing banks to examine "the presentation on its face" against the terms of the credit.[72] That the issuing bank is freed from making any determinations beyond the face of the documents

themselves is presumably one reason letters of credit are cheaper and easier to obtain than surety bonds.[73] This simplicity is also a benefit for named beneficiaries because they can make a determination on their own and receive funds quickly to continue a construction project on schedule.

Often, the original letter of credit itself will be one of the documents required for presentation. Where this is the case, one concern may be with a letter of credit that is lost, stolen, or destroyed. Because the issuing bank may be liable on two credits if the true original resurfaces, the bank may be loath to issue a replacement copy. Additionally, even if the original has been undeniably destroyed, the bank may be unsure of its ability to get reimbursed from the applicant contractor if it unilaterally issues a replacement copy. While Article 5 and the UCP are both silent on the issue of replacement copies, the ISP98 specifies that an issuer of a letter of credit may issue a replacement copy at its discretion.[74] Because the ISP98 is intended to codify standard practices, however, courts are likely to allow banks to reissue even those letters of credit not expressly subject to the ISP98.

Revocable Versus Irrevocable

In an earlier version of the UCP, letters of credit were presumed to be revocable by the issuing bank unless expressly stated to be irrevocable. Before the 1995 revision, Article 5 was silent on revocability, and so subject to the same interpretation. As a result, a standard requirement for letters of credit is that they be irrevocable. Changes to both the UCP (1993) and Article 5 (1995) now make it clear that a letter of credit is presumed to be irrevocable unless it says otherwise.[75] The ISP98 goes further and stipulates that all standbys are irrevocable.[76] Revocable letters of credit are so rare today that one author noted that "many bankers, even those experienced in documentary credits, have never seen a revocable credit. . . ."[77] Although the term *irrevocable* continues to appear in letters of credit, and often in government regulations detailing requirements for letters of credit on public projects, all letters of credit today are irrevocable unless they clearly state otherwise.

Choice of Law

Article 5 allows the parties to freely choose what law will apply and in what venue any disputes will be litigated, assuming the named forum has appropriate subject matter jurisdiction.[78] If the letter of credit is silent on the choice of law, however, the UCP and the ISP98 both reference the local law of the issuing bank as the applicable law. Although most letters of credit in small public or affordable housing projects will likely be issued locally and although most state law is consistent with Article 5 regardless, it is worth checking for any important differences in the relevant state law for a letter issued by a foreign bank.

Drawing on a Standby Letter of Credit

Letters of credit are typically obtained when the relationships among the parties are good, with the assumption that the letter of credit will not

need to be relied upon. As a result, beneficiaries are often not as careful as they should be in reviewing the documentary and other conditions of the letter of credit. When an owner does need to rely on a standby letter of credit, however, those good relationships will likely have soured and the project may be in a crisis mode. As a result, it is important for the parties to understand and pay close attention to the specific conditions written into the credit initially, as well as to the standards with which their performance under those conditions will ultimately be assessed.

Strict Compliance

One important benefit of standby letters of credit is that demanding payment on such letters is simple. That simplicity is achieved in part by the strict enforcement of clear rules, particularly regarding the documents presented for payment. Documents presented for payment on a letter of credit must be in conformity with the requirements written into the credit, including the particular presenting officer, the language and form of presentation, the physical location, and timing. One early English court emphasized that "[t]here is no room for documents which are almost the same, or which will do just as well."[79] Although this pronouncement may seem clear, what it means in practice can be surprising.

The UCP refers simply to "international standard banking practice" as the standard of documentary review.[80] The majority of courts have read this general standard to mean strict compliance, which has meant that spelling errors and other obviously trivial defects in the wording of the documents presented are acceptable.[81] However, statements with even seemingly trivial differences have occasionally justified dishonor. One court held that the language *any bonds or undertakings* was sufficiently different from *aforementioned bonds or undertakings* to justify the bank's denial of the draw.[82] Another court supported a bank's refusal to allow a draw with documents that included a waiver by the applicant of a notice requirement, rather than an affidavit by the beneficiary that such notice had been provided the applicant.[83]

Conversely, the ISP98 has been criticized for its admittedly limited inclusion of a "mirror image" rule rather than the "strict compliance" that the majority of courts have read the UCP to require.[84] Although the ISP98 has a general provision that allows for quoted language to correct typos, it only directly discusses errors in the original that may be corrected in the draft, rather than typographical errors in the draft that may have been correct in the original.[85] Of more concern, however, is the rule providing that draft language that is required to be "exact" or "identical" by the terms of the letter must perfectly replicate "typographical errors in spelling, punctuation, spacing and the like, as well as blank lines and spaces for data."[86] As such, although it is always preferable to be precise about the exact wording intended be used in an eventual draft, the words *exact* or *identical* themselves should be avoided when incorporating the ISP98. Al-

ternatively (or additionally), an issuing bank may be willing to expressly state that ISP98 Rule 4.09(c) is not intended to apply to the credit.

Given the specificity of the language required in the standby itself, beneficiaries might be excused for looking solely to the language of a particular standby for the complete demand requirements. The ISP98, however, incorporates some standard demand requirements in the text of the rules, such that beneficiaries not familiar with the ISP98 rules may be surprised at having presented a noncomplying draft. Although these requirements are admittedly basic, such as reference to the original letter of credit itself,[87] the amount of payment demanded,[88] and the date the demand is being made,[89] it is also simple and reasonable to require the letter of credit to state this information clearly. In particular, most letters of credit already clearly specify this data as a requirement for presentation, and the ISP98 rules are meant simply to codify existing practice. For a letter of credit made subject to the ISP98, beneficiaries should be careful to ensure that the draft language specified in the text of the credit itself includes all the information that the ISP98 requires for a draw.

Notice of Discrepancies

Although issuing banks can refuse to honor a draw if the documents presented do not strictly comply with the documents required in the letter of credit itself, under both the UCP and the ISP98, the bank must identify any such discrepancies with particularity.[90] If a bank does not give notice of a particular discrepancy within the timeframe noted above, then the bank is prohibited from asserting that discrepancy as a reason for dishonor.[91] However, the ISP98 specifies that the failure of the issuer to specifically mention the expiration of the letter of credit is not precluded as a reason for dishonor.[92] Article 5 also includes a similar rule, presumably because it is an incurable default and the beneficiary could hardly be said to have relied upon the lack of notice.[93] Although this is an Article 5 rule rather than a UCP rule, Article 5 still operates in the background where a letter of credit specifically incorporates another body of law.[94] The only exceptions to this rule are for fraud or forgery, which are often not discovered by the bank until after the draft has been honored.[95] This rule enhances the certainty and finality of letters of credit.

Reasonable Time to Honor

Another advantage for beneficiaries of standbys is that payment on the standby will be quick: all applicable rules give the issuer a maximum of seven business days to either honor the draw or to provide notice of specific documentary discrepancies justifying dishonor.[96] Whereas sureties must investigate the underlying situation and contract before paying or performing, banks issuing letters of credit simply have to review the documents presented and ensure that they conform on their face to the requirements of the letter of credit. To perform this review, Article 5 and the UCP both give the issuer a “reasonable time” to honor the draft or to notify the ben-

eficiary of discrepancies or defects in the documents presented.[97] Although a reasonable time is dependent on all the circumstances surrounding a particular transaction and the standard practices of issuing institutions, the UCP sets an outside limit of seven banking days from the date of initial presentation of the documents to the issuing bank. However, where documentary evidence presented is relatively straightforward, as should be the case with all standbys used in lieu of surety bonds, the beneficiary owner should be able to expect a definitive response from the issuing bank in less than seven days.

The ISP98 goes further, however, and establishes a safe harbor minimum of three business days as explicitly "not unreasonable." This provision alone might be reason enough for banks to incorporate the ISP98 rather than the UCP,[98] although this may also be one area where the UCP is actually preferable than the ISP98 to the beneficiary of a very simple standby. If the only document the bank has to examine is a draft, even just three days may not be a reasonable time under the UCP. The creation of this safe harbor poses little difficulty to beneficiaries, however, and can be shortened if necessary by specific language in the letter of credit.

Forgery and Fraud

As noted earlier, a standby letter of credit ensures prompt payment to the beneficiary in the case of default by the contractor. If the documents presented comply with the documents required, the bank can only refuse to honor them if there is evidence of fraud or forgery.[99] The UCP is silent on what constitutes fraud, so the result is that state law in the appropriate jurisdiction will apply; conversely, the ISP98 is explicit in deferring the standard for fraud to local law.[100] As a result, Article 5 will govern the standards for fraud or forgery.[101]

Regarding the relatively simple standby letters of credit discussed here, the official comments to Article 5 specifically note that "it would be possible but difficult" for there to be fraud in the presentation documents for a "clean" letter of credit.[102] A clean letter of credit is one requiring only a draft and no other supporting documents, such as should be the case with standbys used in the construction context. Although the U.C.C. allows for the possibility that a beneficiary receiving payment on a letter of credit based on fraudulent documents will be required to reimburse the bank,[103] the beneficiary will, in the meantime, have access to funds necessary to continue and complete the project.

It is important to emphasize that this exception for fraud or forgery applies only to that found in the documents themselves or otherwise committed by the beneficiary against the issuer, and not to any possible fraud in the underlying transaction. Most courts have construed U.C.C. § 5-114 narrowly as requiring "egregious" or "intentional" fraud that has interfered with the legitimate purposes of the bank's independent obligation.[104] Issuing banks are required only to accept documentary evidence at face value and do not undertake to independently verify the genuineness of the

documents.[105] However, once fraud is established, the bank may be required to show that it had notice of the fraud prior to dishonoring the letter of credit in order for that dishonor to be justified under Article 5.[106]

Damages

Despite the relative simplicity of the documentary requirements of standbys used in lieu of surety bonds, issuers will occasionally refuse to honor a presentation. Where they do so wrongfully, neither the UCP nor the ISP98 discusses damages, and so the Article 5 rules apply. Article 5 allows beneficiaries to recover incidental but not consequential or punitive damages from the wrongful dishonor of a letter of credit.[107] In the meantime, beneficiaries are under no obligation to mitigate any damages. Overall, this limited liability on the part of issuers should keep the costs of letters of credit low, which is part of their attraction for smaller contractors. Issuers will still be encouraged to honor accurate drafts, however, by the requirement that they pay reasonable attorney fees and the direct costs of litigation, as well as incidental damages.

Conclusion

Standbys are admittedly subject to a seemingly bewildering array of rules and laws. Even the banks that promulgate many of these rules have not settled definitively on whether to use the ISP98 or the UCP for the simplest standbys. The precision and detail of the UCP and more especially of the ISP98, however, are intended to maintain confidence in the continued use and acceptance of standby letters of credit for a wide range of assurances across diverse industries and throughout the world. Although standbys might be new to public and affordable housing developers, they are well-used and trusted commercial instruments.

If an otherwise qualified contractor has been unable to obtain a surety bond, the developer should first be sure that the contractor has tried a number of sureties and specifically sought out resources for small contractors within the surety industry, such as the SBA's SBG Program. If after making those inquiries, the contractor still cannot qualify for a bond, the developer should understand more about exactly why the contractor does not qualify. If the developer is confident and still wants to proceed with that contractor, then a standby letter of credit will provide strong protection against any loss in the event of a default.

The construction of multifamily apartments or housing in a neighborhood represents a significant opportunity for an entire community, not just for the future residents of the particular development. Public and affordable housing developers know this, and they often specifically seek to employ local residents and to contract with small and emerging businesses. Where they can provide these opportunities without jeopardizing the final product, doing so is an integral part of their mission.

1. According to the International Chamber of Commerce (ICC), in 1997 the total value of outstanding standbys exceeded the value of traditional commercial credits by five to one. Press Release, International Chamber of Commerce, First Rules Introduced on Standby Letters of Credit (October 29, 1998), *at* www.iccwbo.org/home.news_archives/1998/first_rules_for_letters_of_credit.asp.

2. *See* B. Lynn Kremers, *Letters of Credit: Should Revised Article 5 of the Uniform Commercial Code Be Adopted in Missouri*, 65 UMKC L. Rev. 567, 567 (1997).

3. Daniel E. Toomey & Tamara McNulty, *Surety Bonds: A Basic User's Guide for Payment Bond Claimants and Obligees*, 22-WTR Construction L. 5, 6 (Winter 2002).

4. For examples of the variety of uses, see Reinhard Längerich, Documentary Credits in Practice 242–44 (Sys Bundgaard trans., 2000).

5. Types of standby letters of credit include performance standbys, advance payment standbys, bid bond standbys, counter standbys, financial standbys, direct pay standbys, and insurance standbys. *See* Inst. of Int'l Chamber of Commerce, International Standby Practices 5–6 (1998). This paper technically discusses only performance and advance payment standbys, but as there is no need to discuss them separately, they are referred to by the generic term *standbys.*

6. Although the institutions issuing letters of credit are almost always banks, technically any entity can issue a letter of credit. *See* Katherine A. Barski, *Letters of Credit*, 41 Loy. L. Rev. 735, n.51 (1996). The Uniform Customs and Practice for Documentary Credits issued by the ICC uses language such as *issuing bank* or *confirming bank*, but a letter of credit can construe such language as referring to the issuer whether a bank or not. Comm'n on Banking Technique and Practice, Int'l Chamber of Commerce, When a Non-Bank Issues a Letter of Credit (October 30, 2002), *at* www.iccwbo.org/home/statements_rules/statements/2002/when_a_non-bank_issues.asp.

7. For instance, most construction contracts include a retainage fee of some percentage from each draw, such that the contractor has an incentive to complete the entire project.

8. A possible additional justification for the 25 percent rule is that it would likely cover the primary market-rate lender's loan-to-value ratio.

9. For example, a HUD publication, *Instructions to Bidders for Contracts*, refers to "a payment and performance bond in a penal sum of 100 percent of the contract price." Office of Public & Indian Affairs, HUD, Instructions to Bidders for Contracts: Public and Indian Housing Programs, HUD-5369, § 10, at 3 (Oct. 2002) [hereinafter HUD].

10. Sur. Info. Office, Sur. Bonds Versus Bank Letters of Credit (2003), *available at* www.sio.org/HTML/SBvsLOC.html.

11. For a list of local surety bond producers participating in the SBG Program, contact the SBA's SBG area offices, listed at http://sba.gov/osg, or call 202-205-6540.

12. For an alternative argument that letters of credit simply provide independent verification of information about the purchaser rather than a means to force payment in a dispute, see Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 Mich. L. Rev. 2494 (2000). Mann's empirical

analysis of the actual use of commercial letters of credit is that discrepancies in the presentation of documents are quite often waived by the applicants. Specifically, in 500 transactions that Mann researched, the draw documents conformed to the letter of credit just 27 percent of the time. *Id.* at 2497. But Mann's focus on commercial letters of credit means that the parties are most often drawing on the credit in the ordinary course of business, whereas a draw on a standby means there has been a default. As a result, applicants to standbys are less likely to waive discrepancies.

13. Leslie King O'Neal, *They're Back: Letters of Credit Provided in Lieu of Surety Bonds*, 13-JAN Construction L. 3, 4 (Jan. 1993).

14. U.C.C. § 5-103 cmt. 1.

15. The effectiveness of these updates may be exaggerated, however. *See* Stanley P. Sklar, *The Construction Loan: Who Really Pays for the Project? What Happens When the Loan is in Trouble?*, 491 PLI/Real 9, 24–25 (Apr. 2003) ("When a default has been declared by an owner, the surety generally has little or no information regarding the nature of the default or the status of the construction project.").

16. See Toomey & McNulty, *supra* note 3, at 7–8. Also, for seemingly minor or temporary problems, contractors often may seek assistance directly from the developer, and this is particularly so with regard to projects where the contractor is also a partner in the development entity. However, any such assistance should be provided only with great caution. If the developer provides assistance without notifying the surety, the surety may be absolved of any liability if the contractor later defaults.

17. Again, the SBA's SBG Program, *supra* note 11, should also help to achieve this goal.

18. In the case of the MSHDA Direct Lending Program, for example, contractors can provide what is called a Completion Assurance Agreement, which specifically allows for an "irrevocable letter of credit issued to the Authority by a commercial bank acceptable to an Authorized Officer of the Authority." Mich. State Hous. Dev. Auth., Completion Assurance Agreement, Form Legal 021 (July 1998)

19. MSHDA's lending program mentioned earlier is an exception because it often acts as a primary lender where that program is involved.

20. 4 C.F.R. 85.36(h). Part 85 also applies to HOPE VI funds pursuant to the Mixed-Finance Regulations at 24 C.F.R. 941, and through the text of the HOPE VI grant agreements themselves.

21. *See* HUD, *supra* note 9.

22. For slightly out-of-date, but comprehensive, information on the various state laws requiring bonds on public projects, see James J. Mercier, *Little Miller Acts: Liability of Public Owners for Failure to Obtain Payment on Public Construction Projects*, 14-Construction Law. 7 (1994).

23. See *infra* section entitled Governing Laws Regarding Standby Letters of Credit.

24. 40 U.S.C. §§ 3131-33 (2004).

25. *See* Toomey & McNulty, *supra* note 3, at 5.

26. *Id.* at 41. Because of the similarities, state courts often look to federal court decisions when interpreting the state requirements. *See*, *e.g.*, Granite Constr. Co. v. Am. Motorists Ins. Co., 34 Cal. Rptr. 2d 835, 838 (Cal. Ct. App.

1994) (citing Coast Elec. Co. v. Indep. Indemnity Co., 193 Cal. Rptr. 74 (Cal. Ct. App. 1983)).

27. U.S. Office of Fed. Procurement Policy, Letter 91-4 (1991).

28. *See* Helm, *Bid Guarantee and Surety Bond Update*, 1992-AUG Army Law. 30, 31 (Aug. 1992).

29. 48 C.F.R. 52.228-14(c)(2)(i).

30. The text of Michigan's version of the Miller Act says that "[b]efore any contract exceeding $50,000 . . . is awarded, the proposed contractor . . . shall furnish at his or her own cost to the governmental unit a performance bond and a payment bond." Mich. Comp. Laws § 129.201.

31. O'Neal, *supra* note 13, at 3. For example, letters of credit do not require consideration. *See* U.C.C. § 5-105. Although the applicant will typically pay consideration to the issuer, such consideration (assuming any) would be difficult for the beneficiary alone to subsequently prove.

32. For example, U.C.C. § 5-114(f) says, "Neither the rights recognized by this section . . . nor the . . . payment of proceeds to an assignee . . . affect the rights between the assignee and any other person." The comparable law as adopted in Michigan, Mich. Comp. Laws § 440.5114(6), says, "The rights recognized by this section . . . or the payment of proceeds to an assignee . . . do not affect the rights between the assignee and any other person."

33. U.C.C. § 5-103 cmt. 2.

34. Int'l Chamber of Commerce, Uniform Custom and Practice for Documentary Credits, Publication No. 500 (1993) [hereinafter UCP]. This publication may be obtained for $11.95 from ICC Publishing, Inc., at 156 Fifth Avenue, New York, NY 10010, or at 212-206-1150.

35. Although only two of the Article 5 reservations have any impact on the rules discussed here, both are noted below. For a more detailed discussion of all the Article 5 reservations, see Kremers, *supra* note 2.

36. U.C.C. 5-103 cmt. 2; *see also* Amwest Sur. Ins. Co. v. Concord Bank, 248 F. Supp. 2d 867 (E.D. Mo. 2003).

37. UCP, *supra* note 34, art. 1.

38. For a detailed description of why the UCP rules on commercial letters of credit are not ideal for standby letters of credit, see James E. Byrne, *Standby Rulemaking: A Glimpse at the Elements of Standardization and Harmonization of Banking Practice*, New Dev. in Int'l Com. and Consumer L. 135, 145–49 (1998).

39. Int'l Chamber of Commerce, International Standby Practices ISP98 (1998) [hereinafter ISP98]. This publication may be obtained from the same address in note 34. Although the ISP98 is published by the ICC, it was written primarily by the Institute of International Banking Law & Practice and endorsed by the ICC. For a description of how the ISP98 rules were drafted and why the ICC adopted them, see Paul S. Turner, *New Rules for Standby Letters of Credit: The International Standby Practices*, 14 Banking & Fin. L. Rev. 457, 458–61 (1999).

40. However, the forward to the ISP98 emphasizes that "standbys can still be subjected to the UCP, if the parties determine it is their wish to do so." Maria Livanos Cattaui, Secretary General of ICC, *Forward* to ISP98, *supra* note 39, at 3.

41. This is the case although "even the least complex standbys (those calling for presentation of a draft only) pose problems not addressed by the UCP." ISP98, *supra* note 39, at 6.

42. In addition to institutional inertia on the part of banks, the text of the FAR requires that standbys issued on federal construction projects be subject to the UCP. Perhaps the desire to reference one consistent set of rules is another reason many banks continue to reference the UCP.

43. One advantage to the ISP98 not discussed here relates to rules regarding electronic presentation of documents. *See* ISP98, *supra* note 39, R. 1.09(c), 3.06, 3.11(c), 4.07(b), 4.15(b).

44. *See infra* section entitled Expiration and Extension.

45. Often, the named beneficiary is required to deposit the proceeds of the credit in an escrow account until the various parties work out how the funds should be distributed.

46. Despite this fact, this paper refers to the *developer beneficiary* rather than to the *lender beneficiary* in order to eliminate confusion with the *issuing bank.* Keeping the relationships of the various parties to the credit straight is more important than emphasizing the particular named beneficiary.

47. *See* Arbest Constr. Co. v. First Nat'l Bank & Trust, 777 F.2d 581 (10th Cir. 1985) (holding that subcontractors not named in the letter of credit were not third-party beneficiaries and thus were not eligible to draw on the letter).

48. *See* W. Waterproofing Co. v. Springfield Hous. Auth., 669 F. Supp. 901 (C.D. Ill. 1987) (holding that a subcontractor can assert a breach of contract directly against the owner for failure to procure a required payment bond from the contractor).

49. O'Neal, *supra* note 13, at 4.

50. 48 C.F.R. 52.228-14(e)(4).

51. UCP, *supra* note 34, art. 49.

52. ISP98, *supra* note 39, R. 6.06, 6.07.

53. U.C.C. § 5-114(d).

54. The expiry date refers to the date by which complete documents for a draw must have been submitted by the beneficiary to the proper location, rather than the date by which the issuing bank must have transferred payment to the beneficiary. Katherine A. Barski, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 Loy. L. Rev. 735 (1996) (citing Reade H. Ryan, Jr., *General Principles and Classifications of Letters of Credit*, R182 ALI-ABA 221, 235 (Mar. 10, 1994)).

55. Aluminum Corp. v. Bank of Virginia, 704 F.2d 136 (4th Cir. 1983).

56. There is some evidence in sales transactions that banks frequently honor letters of credit even after expiration upon waiver of the deficiency by the applicant. *See* Mann, *supra* note 12. However, in sales transactions the letters of credit often actually serve as the means of payment rather than just insurance in the case of dispute. Thus, a buyer with ongoing commercial relationships is likely to waive a technical deficiency, whereas a contractor who has gone bankrupt or materially breached a contract is not likely to provide such waiver. Even if he does, however, the issuing bank is not required to waive the deficiency and surely wouldn't do so where the applicant is likely unable to reimburse the bank.

57. *See infra* section entitled Strict Compliance.

58. UCP, *supra* note 34, art. 42(a); ISP98, *supra* note 39, R. 9.01.

59. The ISP98 rules do suggest that a standby must either "contain an expiry date" or "permit the issuer to terminate the standby upon reasonable prior notice or payment." ISP98, *supra* note 39, R. 9.01. However, both options appear

to be affirmative requirements rather than identification of the termination and notice clause as a default rule.

60. U.C.C. § 5-106(d).

61. *Id.* § 5-103(c).

62. For example, the format required by the federal government's acquisition regulations requires that "unless the issuer provides the beneficiary written notice of non-renewal at least 60 days in advance of the current expiration date, the [letter of credit] is automatically extended without amendment for one year." 48 C.F.R. 52.228-14(c)(2).

63. In AXA Assurance, Inc. v. Chase Manhattan Bank, 770 A.2d 1211 (N.J. Super. Ct. App. Div. 2001), a separate paragraph in the letter of credit indicated a date beyond which extension was not automatic, and the issuer rightfully dishonored a presentation after that date despite not having expressed an intent to allow the letter to expire.

64. As a guide, the FAR requires that on projects subject to the Miller Act, extensions without amendment be available at least until one year following the date of expected payment. 48 C.F.R. 52.228-14(c)(2)(i).

65. ISP98, *supra* note 39, R. 3.09.

66. UCP, *supra* note 34, art. 4 ("In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate.").

67. For practitioners only familiar with the simplest letters of credit, the term *sight draft* occasionally causes some confusion as to whether payment is due on sight or whether there is some separate document required by that term. In the context of letters of credit generally, the term *sight draft* appears simply to distinguish those standbys requiring payment immediately upon examination and approval of specified documents (the draft), from the more complex "deferred payment" or "negotiation draft." *See Id.* art. 10(a).

68. *Id.* art. 13(c) ("[I]f a Credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them."). ISP98 Rule 4.11 defines *non-documentary condition* as a term that "does not require presentation of a document" or that "cannot be determined by the issuer from the issuer's own records" and says that such terms are to be disregarded. Although this rule may seem to be significantly helpful to the beneficiary of a letter of credit, at least one commentator has suggested that a letter of credit containing a non-documentary condition that is "fundamental to the issuer's obligation to the beneficiary" may not be a letter of credit at all and thus not subject to the ISP98. *See* Turner, *supra* note 39, at 482–85. As a result, such conditions should be avoided in the first place.

69. U.C.C. § 5-108.

70. UCP, *supra* note 34, art. 13(a).

71. ISP98, *supra* note 39, R. 4.01(b).

72. *See, e.g.*, Dellas W. Lee, *Letters of Credit: What Does Revised Article 5 Have to Offer Issuers, Applicants, and Beneficiaries?*, 101 Comm. L.J. 234, 241 (1996).

73. ISP98, *supra* note 39, R. 3.12.

74. UCP, *supra* note 34, art. 6(a); U.C.C. § 5-106(a).

75. ISP98, *supra* note 39, R. 1.06(a).

76. Längerich, *supra* note 4, at 74.

77. U.C.C. § 5-116.

78. Lord Sumner, *Equitable Trust Co. v. Dawson Partners, Ltd.*, 27 Lloyd's List L. Rep. 49, 52 (H.L. 1927).

79. UCP, *supra* note 34, art. 13(a).

80. *See, e.g.*, New Braunfels Nat'l Bank v. Odiorne, 780 S.W. 2d 313 (Tex. App. 1989); *see also* Tosco Corp. v. Fed. Deposit Ins. Corp., 723 F.2d 1242 (6th Cir. 1983).

81. Occidental Fire & Cas. Co. v. Cont'l Ill. Nat'l Bank and Trust, 718 F. Supp. 1364, 1369 (N.D. Ill. 1989).

82. LeaseAmerica Corp. v. Northwest Bank Duluth, N.A., 940 F.2d 345, 347–48 (8th Cir. 1991).

83. *See* Turner, *supra* note 39, at 473–82; *see also* John F. Dolan, *Analyzing Bank Drafted Standby Letter of Credit Rules, The International Standby Practice* (ISP98), 45 Wayne L. Rev. 1865, 1890–91 (referring to the mirror image rule as "procrustean" and suggesting that courts may refuse to enforce it).

84. ISP98, *supra* note 39, R. 4.09 cmt. 5 (referring to R. 4.09(b) but not to R. 4.09(c)).

85. *Id*. R. 4.09(c).

86. *Id*. R. 3.03(a).

87. *Id*. R. 4.16.

88. *Id*. R. 4.17.

89. UCP, *supra* note 34, art. 14(d)(2); ISP98, *supra* note 39, R. 5.02; *see also* U.C.C. § 5-108(c).

90. UCP, *supra* note 34, art. 14(e); ISP98, *supra* note 39, R. 5.03(a).

91. ISP98, *supra* note 39, R. 5.04.

92. U.C.C. § 5-108(d); *see, e.g.*, Flagship Cruises, Ltd. v. New Eng. Merchants Nat'l Bank, 569 F.2d 699 701 (1st Cir. 1978).

93. In order to avoid even this background application of Article 5, "parties . . . must normally either adopt the law of a jurisdiction other than a State of the United States or state explicitly the rule that is to govern." U.C.C. § 5-103 cmt. 2.

94. *See infra* section entitled Forgery and Fraud.

95. U.C.C. § 5-108(b); UCP, *supra* note 34, art. 13(b); ISP98, *supra* note 39, R. 5.01(a). Although the UCP limit refers to seven "banking days," there will rarely be any difference between a UCP banking day and an Article 5 business day. U.C.C. § 5-108 cmt. 2.

96. The ISP98 refers instead to "a time after presentation . . . which is not unreasonable." ISP98, *supra* note 39, R. 5.01(a).

97. Turner, *supra* note 39, at 489.

98. U.C.C. § 5-109 cmt. 1; U.C.C. § 5-114.

99. ISP98, *supra* note 39, R. 1.05(c).

100. U.C.C. 5-109(1).

101. U.C.C. § 5-109 cmt. 3; *see also* W. Sur. Co. v. Bank of S. Ore., 257 F.3d 933 (9th Cir. 2001).

102. Kathleen Smyth Cook, *Jumping Through the Hoops with Standby Letters of Credit*, 8-APR Prob. & Prop. 24, 28 (Mar./Apr. 1994).

103. *See, e.g.*, Colo. Nat'l Bank v. Bd. of County Comm'rs, 634 P.2d 32, 39 (Colo. 1981) (describing the requisite fraud as being "of such an egregious nature as to vitiate the entire underlying transaction"); *see also* U.C.C. § 5109 cmt. 1 (1995) (listing relevant cases).

104. *See* Philip A. Feinberg, Inc. v. Varig S.A., 363 N.Y.S.2d 195 (N.Y. App. Div. 1974).

105. *See* Roman Ceramics Corp. v. People's Nat'l Bank, 517 F. Supp. 526 (M.D. Pa. 1981) (applying Pennsylvania law and ultimately holding that the bank did have effective notice).

106. U.C.C. § 5-111.

107. U.C.C. § 5-111(1).