George Mason Journal of International Commercial Law

Vol. 2, Issue 1

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The Journal Staff would like to express our profound appreciation for the George Mason University School of Law faculty and administration, without whom this publication would not have been possible.

We would like to thank our Board of Advisors, and in particular our Faculty Advisor Professor James Byrne. Words cannot express the value of your guidance, insight and assistance.

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ISP98 Rule 3.12(a): Is It A Trap, Or A Warning to An Unwary Beneficiary of a Letter of Credit?

Michael Evan Avidon[1]

Rule 3.12(a) of the International Standby Practices ("ISP98")[2] provides:

> If an original standby[3] [letter of credit] is lost, stolen, mutilated, or destroyed, the issuer need not replace it or waive any requirement that the original be presented under the standby [letter of credit].[4]

Is this rule a trap for an unwary letter of credit beneficiary that accepts a letter of credit that requires presentation of the original letter of credit as a condition to obtaining payment, transferring drawing rights or assigning proceeds of the letter of credit? Or is it a warning to the beneficiary (and its counsel) not to accept such requirement or to vary such rule? At first blush, the rule appears to be a trap, but further analysis shows that it is more of a warning: *Do <u>not</u> condition your rights to obtain payment, transfer drawing rights or assign letter of credit proceeds upon presentation of the original letter of credit because, if the original letter of credit is ever lost, stolen, mutilated, or destroyed, you may be unable to obtain payment, transfer drawing rights or assign letter of credit proceeds.*[5]

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[2] *International Standby Practices 1998 (ISP98)*, Rule 3.12(a), International Chamber of Commerce Publication No. 590 (Jan. 1, 1999) [hereinafter ISP98].

[3] ISP98 defines a "standby" as "[a]n undertaking subject to these Rules . . . ." ISP98, *supra* note 2, Rule 1.01(d) (Scope and Application).

[4] Other ISP98 Rules expressly recognize that the issuer may refuse to effect a transfer of drawing rights or an assignment of letter of credit proceeds if the beneficiary fails to present the original letter of credit. *See id.* Rule 6.03(b)(ii) (Conditions to Transfer), 6.08(a) (Conditions to Acknowledgment of Assignment of Proceeds).

[5] *See id.* Rule 4.15(a) (Original, Copy, and Multiple Documents) (providing that a "presented document must be an original."). Under ISP98, then, the default rule is that an

What is a Beneficiary to Do?

Having been warned of the danger by ISP98 Rule 3.12(a), what can a beneficiary and its counsel do to protect the beneficiary? This article analyzes the following four options:

1. Choose different letter of credit rules, practices, or law to govern the letter of credit.

2. Refuse to accept a letter of credit that requires presentation of the original letter of credit.

3. Accept the requirement that the original letter of credit be presented but build in a mechanism for replacement of the original or waiver of the requirement where appropriate.

4. Accept the requirement that the original letter of credit be presented and take steps to safeguard the original letter of credit.

1. Do Other Letter of Credit Rules Afford More Protection to Beneficiaries?

The first option beneficiaries may consider is whether other rules could be chosen to better protect a beneficiary whose original letter of credit is lost, stolen, mutilated, or destroyed. This part examines whether beneficiaries can find better protection under the 2007 revision of the Uniform Customs and Practice for Documentary Credits (UCP600),[6] or the Uniform Commercial Code Revised Article 5 (UCC Rev. Article 5).[7]

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original is required unless the letter of credit states otherwise. *Id*. This understanding is implicit in standard letter of credit practice. *See* JAMES E. BYRNE, ISP98, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES 179–80 (James G. Barnes ed., 1998).

[6] *Uniform Customs and Practice for Documentary Credits (UCP600)*, International Chamber of Commerce Publication No. 600 (July 1, 2007) [hereinafter UCP600].

[7] Rev. U.C.C. Article 5 (1995).

A. UCP600

UCP600 does not contain a specific provision dealing with lost, stolen, mutilated, or destroyed letters of credit but its general provisions appear to reach the same result as ISP98 Rule 3.12(a), with one limited exception. UCP600 Articles 7(a) (Issuing Bank Undertaking) and 8(a) (Confirming Bank Undertaking) both provide that an issuing bank or a confirming bank, respectively, is obligated to honor a letter of credit only if "the stipulated documents are presented to the . . . bank and . . . they constitute a complying presentation . . . ." UCP600 Article 2 (Definitions) defines a "[c]omplying presentation" as a "presentation that is in accordance with the terms and conditions of the [letter of] credit, the applicable provisions of these [UCP 600] rules and international standard banking practice." UCP600 Article 38(a) (Transferable Credits) provides that "[a] bank is under no obligation to transfer a [letter of] credit except to the extent and in the manner expressly consented to by that bank." Thus, if the letter of credit requires the presentation of the "original" letter of credit, the beneficiary's failure to provide the "original" letter of credit would generally constitute a non-complying presentation, warranting dishonor by the issuer.

The limited exception in UCP600 to these general provisions relates to documents lost in transit from a nominated bank, but it does not extend to a beneficiary that is unable to present documents to the issuing bank or a nominated bank because they have been lost, stolen, mutilated, or destroyed:

> If a nominated bank determines that a presentation is complying and forwards the documents to the issuing bank or confirming bank, . . . an issuing bank or confirming bank must honour or negotiate, or reimburse that nominated bank, even when the documents have been lost in transit between the nominated bank and the issuing bank or confirming bank, or between the confirming bank and the issuing bank.[8]

This exception applies only to documents lost in transit between certain banks *after* the beneficiary has made a complying presentation and, in effect, makes the banks responsible for that loss. With this limited exception, UCP600 affords no more protection than ISP98 to a beneficiary

[8] UCP600, *supra* note 6, Art. 35 (Disclaimer on Transmission and Translation).

that is unable to comply with a requirement for presentation of the original letter of credit.

B. UCC Revised Article 5

UCC Rev. Article 5 also does not contain a specific provision dealing with lost, stolen, mutilated, or destroyed letters of credit but, again, its general rules appear to reach the same result as ISP98 Rule 3.12(a) (Original Standby Lost, Stolen, Mutilated, or Destroyed). UCC Rev. § 5-108(a) (Issuer's Rights and Obligations) provides that "an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection [5-108](e), appears on its face strictly to comply with the terms and conditions of the letter of credit." UCC Rev. § 5-112(b) (Transfer of Letter of Credit) provides that "[e]ven if a letter of credit provides that it is transferable, the issuer may refuse to recognize or carry out a transfer if: . . . (2) the transferor or transferee has failed to comply with any requirement stated in the letter of credit . . . ." Thus, UCC Rev. Article 5 affords no more protection than ISP98 or UCP600 to a beneficiary that is unable to comply with a requirement to present the original letter of credit because it has been lost, stolen, mutilated, or destroyed.

Prior versions of the Uniform Customs and Practice and of Uniform Commercial Code Article 5 were also no more protective of beneficiaries. They too did not contain any specific provision dealing with lost, stolen, mutilated, or destroyed letters of credit, but their general rules required compliance with the terms and conditions of the letter of credit and so posed a danger to a beneficiary whose original letter of credit was required to be presented but was lost, stolen, mutilated, or destroyed.[9]

United States courts have applied these general rules in cases where the beneficiary failed to present the original letter of credit as required by the terms of the letter of credit.[10]

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[9] *See, e.g.*, *Uniform Customs and Practice for Documentary Credits (UCP500)*, Art. 9(a), International Chamber of Commerce Publication No. 500 (Jan. 1, 1994) (providing that the issuing bank undertakes to honor "provided that the stipulated documents are presented to the Nominated Bank or to the Issuing Bank and that the terms and conditions of the Credit are complied with . . . ."); U.C.C. § 5-114(1) (1994). The previous version of U.C.C. Article 5, the original Article 5, provided that "[a]n issuer must honor a draft or demand for payment which complies with the terms of the relevant credit . . . .". *Id.*

[10] *See* Brul v. MidAmerican Bank & Trust Co., 820 F. Supp. 1311 (D. Kan. 1993) (holding that where the letter of credit called for presentation of the original letter of credit and an original promissory note to draw, and where instead photocopies were presented and an

The bottom line is that other letter of credit rules do not appear to be more protective of letter of credit beneficiaries than ISP98 Rule 3.12(a) (Original Standby Lost, Stolen, Mutilated, or Destroyed). Therefore, beneficiaries should not seek refuge under UCP600 or UCC Rev. Article 5 to protect themselves from the risk of having their original letter of credit lost, stolen, mutilated, or destroyed.

2. Refuse to Accept a Letter of Credit That Requires Presentation of the Original Letter of Credit

Another option available to a beneficiary is to simply refuse to accept a letter of credit that requires presentation of the original letter of credit as a condition to obtaining payment, transferring drawing rights or assigning letter of credit proceeds. Will a savvy issuing bank, confirming bank, or their applicant agree to issue the letter of credit without that requirement? To put it another way, why is the requirement there in the first place? Does it serve a legitimate purpose of the issuing bank or confirming bank or their applicant, or is it simply a trap for an unwary beneficiary?

Some reasons that have been asserted for requiring presentation of the original letter of credit are:

1. It reduces the risk of letter of credit fraud.[11]

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accompanying affidavit stated that the originals were lost or destroyed, the copies failed to meet the requirements for strict or even substantial compliance with the terms of the letter of credit, so the issuing bank was not obligated to pay the drawing); Airlines Reporting Corp. v. Norwest Bank, N.A., 529 N.W.2d 449 (Minn. Ct. App. 1995) (holding that where the letter of credit required presentation of the original letter of credit, failure to do so justified dishonor). *Cf.* LaBarge Pipe & Steel Co. v. First Bank, 550 F.3d 442 (5th Cir. 2008) (where letter of credit required that the "original Irrevocable Letter of Credit" be presented for drawing and the beneficiary presented a facsimile of the letter of credit, the presentation was non-complying but the issuing bank was precluded from asserting the discrepancy under UCP400 Article 16(e), which required the bank to give notice of dishonor "without delay by telecommunications or, if that is not possible, by other expeditious means," because the issuing bank's mailed notice of dishonor could have been given "virtually immediately, or at least in fewer than three days"). Note that in *LaBarge* the issuing bank apparently never provided the signed original letter of credit to the beneficiary but provided only a facsimile copy of the signed original with a fax cover sheet that stated, "Here is the letter of credit you requested." *Id.* at 446, 453. Perhaps in those circumstances the court should have held that the facsimile copy provided by the issuing bank to the beneficiary was the "original" that was required to be presented.

[11] *See* James G. Barnes & James E. Byrne, *Letters of Credit,* 64 BUS. LAW 1219, 1220 (2009) ("Conditioning honor on presentation of the letter of credit is atypical but not an unusual or bad practice. When imposed, such conditions are strictly enforced, which may

2. It makes it easier to track payments, transfers and assignments.[12]

3. It is no great burden on a beneficiary to take good care of the original letter of credit.[13]

4. It is not an uncommon letter of credit provision.[14]

While some merit exists for each of these reasons, the benefits of requiring presentation of an original letter of credit are not likely in most cases to outweigh the risk to the beneficiary that an original letter of credit may be lost, stolen, mutilated, or destroyed. As to the first reason, the risk of dealing with an imposter-beneficiary may be reduced somewhat by requiring the beneficiary to produce the original letter of credit, which, in effect, vouches for the beneficiary's identity like an ID card. However, that risk obviously cannot be eliminated as an imposter might present a stolen original letter of credit or a forged letter of credit.[15]

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deter presentation of forged draws, but also frustrate any presentation under [a letter of credit] that is not in the beneficiary's possession.").

[12] The letter of credit in *LaBarge* stated that "the original Irrevocable Letter of Credit must be presented with any drawing so that drawings can be endorsed on the reverse thereof." 550 F.3d at 451.

[13] *Cf.* Reply of Longview Power, LLC to Staff's Response to Petition of Longview Power, LLC to Post Letter of Credit in Lieu of Funding an Escrow Account, Cases No. 03-1860-E-C-S, 05-1467-E-CN, Longview Power LLC, Pub. Serv. Comm. of W. Va. 2 (Nov. 5, 2007) (arguing that it would "appear to be an inconsequential burden" for the Public Service Commission of West Virginia to have to safeguard the original letter of credit where the petitioner seeks permission to post a letter of credit).

[14] *See* BARNES & BYRNE, *supra* note 11, at 1220 ("Conditioning honor on presentation of the letter of credit is atypical but not an unusual or bad practice.").

[15] *See* U.C.C. § 5-108(i)(5) (1995); U.C.C. § 5-108 cmt. 13 (1995). An issuer is not discharged from its obligations to the true beneficiary under a letter of credit by honoring a presentation containing a forged signature of the beneficiary, so the issuer may have to pay again if the true beneficiary later makes a complying presentation. *See id*. Likewise, the applicant is not discharged from its obligation to reimburse the issuer for a complying presentation by the true beneficiary if it previously reimbursed a drawing by a forger. *See id.* § 5-108(i)(1); § 5-108 cmt. 12; § 5-109(a)(2); § 5-109 cmt. 2. Official Commentary to U.C.C. § 5-114 recognizes that "[w]here the letter of credit must be presented as a condition to honor . . . the risk to the issuer or nominated person of having to pay twice is minimized." § 5-114 cmt. 3. An exception to the rule that an issuer is not discharged by honoring a presentation containing a forged beneficiary signature is where a letter of credit

As to the second reason, although drawings, transfers and assignments can be noted on an original letter of credit and the original can be treated much like an old-fashioned bank passbook noting each deposit and withdrawal into a bank account, there are obviously other ways to track drawings, transfers and assignments as many letters of credit do not require presentation of the original (and even where there is such a requirement, banks sometimes agree to waive such requirement or replace an original that has been lost, stolen, mutilated, or destroyed). The case for requiring presentation of the original may be strongest where the letter of credit is available by negotiation at multiple banks. An example of such an arrangement is a "freely negotiable" letter of credit, where each bank that is requested to negotiate drafts drawn under the letter of credit wants to know the current terms and conditions of the letter of credit, including its undrawn amount, as opposed to where the letter of credit is available at only one bank that will always know the undrawn amount of the letter of credit.[16]

As to the third reason, although prudent beneficiaries can take steps to safeguard original letters of credit, such as by storing them in safe deposit boxes and presenting them by relatively secure means, the costs of protective measures can be substantial and no protective measure is

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is governed by Pennsylvania law because Pennsylvania enacted a non-uniform version of U.C.C. § 5-108 that shifts to the beneficiary the risk of the issuer paying based on a forged beneficiary signature. *See* 13 PA. CONS. STAT. ANN. § 5108 cmt. 2 (West 2009). Pennsylvania law discharges the issuer from further liability to the extent that the issuer paid a facially complying presentation over a forged beneficiary signature. *See id.* § 5108(i)(5) (providing that an "issuer that has honored a presentation as permitted or required . . . is discharged to the extent of its performance under the letter of credit").

[16] The drafters of U.C.C. Rev. Article 5 recognized that requiring presentation of the original letter of credit could facilitate tracking transfers and reducing the risk of fraud. *See* U.C.C. § 5-112 cmt. 2 (1995):

> [T]ransferable letters of credit are often issued under circumstances in which a nominated person or adviser is expected to facilitate the transfer from the original beneficiary to a transferee and to deal with that transferee. In those circumstances it is the responsibility of the nominated person or adviser to establish procedures satisfactory to protect itself against double presentation or dispute about the right to draw under the letter of credit. Commonly such a person will control the transfer by requiring that the original letter of credit be given to it or by causing a paper copy marked as an original to be issued where the original letter of credit was electronic. By keeping possession of the original letter of credit the nominated person or adviser can minimize or entirely exclude the possibility that the original beneficiary could properly procure payment from another bank. If the letter of credit requires presentation of the original letter of credit itself, no other payment could be procured.

foolproof. For example, consider the many documents that were destroyed in the September 11, 2001 World Trade Center attacks (including documents contained in safe deposit boxes on premises) and in other disasters such as hurricanes and fires.

As to the fourth reason, although it is true that many letters of credit require presentation of the original letter of credit, that fact alone does not make the practice fair or sensible; it suggests, however, that there may be a legitimate basis for the practice, at least in some contexts.[17]

Although none of the four aforementioned reasons by itself provides a strong basis for fairly requiring the beneficiary to present the original letter of credit or risk forfeiting its rights, there is enough justification and enough precedent that, in the author's experience, banks have refused to dispense with the requirement.

One instance where applicants and beneficiaries have leverage to persuade banks to dispense with the requirement to present the original letter of credit is where regulatory authorities weigh-in against requiring presentation of the original. For example, the Insurance Department of the State of New York issued an opinion on May 27, 2003, that a letter of credit used to comply with certain insurance requirements under 11 N.Y.C.R.R. Part 79, Reg. 133, must not be subject to ISP98 but may be subject to the UCP (then I.C.C. Publication No. 500) and is not permitted to require presentation of the original letter of credit as a condition to drawing. The letter of credit is permitted only to require the presentation of a draft.[18]

There is at least one reason why a prudent beneficiary might want the letter of credit to require presentation of the original as a condition to drawing. Under UCC Rev. § 5-114(d) (Assignment of Proceeds), the issuer is not permitted to unreasonably withhold its consent to an assignment of letter of credit proceeds "if the assignee possesses and exhibits the letter of

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[17] Another possible reason for the presentation requirement is the hope on the part of some issuing banks and applicants that the original will be lost, stolen, mutilated, or destroyed, so the beneficiary will be unable to draw, transfer its drawing rights or assign letter of credit proceeds. This reason, even if real, seems so blatantly unfair that it merits no further discussion.

[18] *See* Re: Letters of Credit & Regulation 133, State of N.Y. Ins. Dep't, The Office of Gen. Counsel (May 27, 2003), *available at* http://www.ins.state.ny.us/ogco2003/rg030523.htm (concluding that all letters of credit issued under Reg. 133 must be "clean and unconditional," which means that the beneficiaries need only present a sight draft and that no other document need be presented).

credit and presentation of the letter of credit is a condition to honor.” So if the beneficiary fears the issuer may unreasonably withhold its consent to an assignment of letter of credit proceeds, the beneficiary can insist that the letter of credit require presentation of the original; then the issuer can withhold its consent only on reasonable grounds. Of course, the beneficiary could also try to achieve this result by insisting on an explicit provision in the letter of credit that the issuer may not unreasonably withhold its consent to an assignment of proceeds.

3. Accept the Requirement but Build-In Protections for the Beneficiary

In the author’s experience, where an issuing bank or a confirming bank or their applicant insists that the letter of credit contain a provision requiring presentation of the original, there are protections for the beneficiary that can be built into the letter of credit that most banks and their applicants have been willing to accept. A typical protective provision would state:

> At the Beneficiary’s request prior to the then current stated expiration date of this Letter of Credit, the Issuer will issue a replacement letter of credit (having the same terms and conditions as this Letter of Credit and any accepted amendments thereto) to the Beneficiary if the Beneficiary returns the mutilated original Letter of Credit to the Issuer or if the Beneficiary certifies to the Issuer that the original Letter of Credit has been lost, stolen or destroyed and provides the Issuer with a reasonably acceptable indemnity from a reasonably acceptable indemnitor.

This protective provision is not foolproof, but it appears to strike a fair balance. For instance, the beneficiary and the issuer could obviously disagree whether the proposed indemnity or a proposed indemnitor is reasonable and might have to resolve their dispute in court or by some other means. This is not ideal, but it is better for the beneficiary to be able to argue that its proposed indemnity and indemnitor are reasonable than to be left without payment if the original letter of credit is lost, stolen, mutilated, or destroyed. Where the beneficiary is financially strong, it may itself be a reasonable indemnitor or may have little trouble procuring a third party to act as a reasonable indemnitor. On the other hand, if the beneficiary is financially weak it may not qualify as a reasonable indemnitor and may be unable to procure a stronger indemnitor.

Provision of an indemnity is consistent with ISP98 Rule 3.12(b), which gives the issuer the option to aid a beneficiary who claims that its letter of credit has been lost, stolen, mutilated, or destroyed:

> If the issuer agrees to replace an original standby or to waive a requirement for its presentation, it may provide a replacement or copy to the beneficiary without affecting the applicant's obligations to the issuer to reimburse, but, if it does so, the issuer must mark the replacement or copy as such. The issuer may, in its sole discretion, require indemnities satisfactory to it from the beneficiary and assurances from nominated persons that no payment has been made.[19]

A corollary issue that the beneficiary and the issuer should address is what, exactly, the beneficiary is required to present when presentation of the "original" letter of credit is one of the terms of the letter of credit.[20] In the case of a letter of credit issued directly by an issuer to the beneficiary in the form of a manually-signed paper document, there may be little doubt that the "original" is that manually-signed piece of paper. However, which document constitutes the "original" becomes less clear if the letter of credit is transmitted electronically by SWIFT[21] directly to the beneficiary. Indeed, it is difficult to see in what sense there is any original if the recipient can print out as many "originals" or "copies" as it wishes from its SWIFT terminal and the printouts are indistinguishable from one another. Or, suppose the issuer transmits the letter of credit by SWIFT to an advising bank that prints out the letter of credit and then sends it to the beneficiary accompanied by a letter of advice manually-signed by the advising bank. It

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[19] ISP98, *supra* note 2, Rule 3.12(b) (Original Standby Lost, Stolen, Mutilated, or Destroyed); *See also* BYRNE, *supra* note 5, at 130 (concluding that ISP98 Rule 3.12(b) permits the issuer to require satisfactory indemnities from the beneficiary and assurances from any nominated person due to the concern that the beneficiary or a third person might use the original letter of credit in a fraudulent manner).

[20] *See International Standard Banking Practice for the examination of documents under documentary credits (ISBP)*, Preliminary Considerations ¶ 1, International Chamber of Commerce Publication No. 681 (2007) ("To avoid unnecessary costs, delays and disputes in the examination of documents . . . the applicant and beneficiary should carefully consider which documents should be required . . . .").

[21] SWIFT, Company Information, http://www.swift.com/about_swift/company_information/index.page?lang=en ("SWIFT is the Society for Worldwide Interbank Financial Telecommunication, a member-owned cooperative through which the financial world conducts its business operations with speed, certainty and confidence.").

is unclear whether the "original" letter of credit is the SWIFT printout (of which there may be many) or the manually signed letter from the advising bank or that letter together with the SWIFT printout.[22]

Although ISP98 does not define the term "original," ISP98 Rule 4.15 (Original, Copy, and Multiple Documents) provides some parameters as to which documents should be treated as originals and which documents should be treated as copies, in addition to the general rule that a presented document must be an original under ISP98. For example, Rule 4.15(c) provides that a "presented document is deemed to be an original unless it appears on its face to have been reproduced from an original."[23] This suggests that whatever one might otherwise consider as an "original," if the document being presented appears on its face to be a reproduction of such an original, then it should not be deemed to be an original but a copy. However, a "copy" or a document that appears to have been reproduced from an original is deemed to be an "original" if the signature or authentication on that "copy" or other document appears to be an original.[24] The terms "signature" and "authenticate" are both defined in ISP98 Rule 1.09 (Defined Terms). A "'signature' includes any symbol executed or adopted by a person with a present intent to authenticate a document."[25] However, the definition of "authenticate" appears to focus on verification of "electronic records."[26] The bottom line is that sometimes it may not be obvious what the "original" letter of credit is.

Even if it is clear what the initial "original" letter of credit is, the beneficiary is still faced with the dilemma of whether it should also present any letter of credit amendments, and whether it matters if the beneficiary has accepted or rejected the amendment(s) or has not yet communicated its response to the amendment.[27] The answer to these issues may depend upon

[22] *Cf.* U.C.C. § 5-104 cmt. 3 (1995) (noting that the letter of credit transmitted by SWIFT may be printed at the advising bank, stamped "original" and provided to the beneficiary in that form).

[23] ISP98, *supra* note 2, Rule 4.15(c)(i).

[24] *Id.* Rule 4.15(c)(ii).

[25] *Id.* Rule 1.09(a) ¶ 12.

[26] *Id.* Rule 1.09(c) ¶ 2.

[27] The issuer faces the same dilemma in deciding whether the terms of its letter of credit require presentation of any or all amendments as well.

how the presentation requirement in the letter of credit is drafted. For instance, does it require presentation of:

a. "the original letter of credit";

b. "the original letter of credit and any amendments thereto";

c. "the original letter of credit and any accepted amendments thereto";

d. "the original letter of credit and any amendments thereto, whether or not accepted or rejected"; or

e. "the original letter of credit but not any amendments thereto"?

Variations (a) and (b) are not as precise as variations (c), (d) and (e), and there is obviously the potential for dispute. Which of variations (c), (d) and (e) makes the most sense depends upon the reason for having the presentation requirement in the first place. If the reason for the requirement is fraud prevention, variation (d) is supported, as each additional scrap of required paper adds some marginal fraud protection. If the reason for the requirement is something else, variations (c) or (e) may be supported.

Another situation for a beneficiary to watch for is when the original letter of credit is never delivered to it. Suppose that the issuer prints out a paper letter of credit, manually signs it, and gives it to the applicant, who gives the beneficiary a photocopy of the signed letter of credit, not the signed original – must the beneficiary present the signed original that it never received or may it present the photocopy or be excused from complying with the requirement? Or suppose the issuer prints out a paper letter of credit and signs it but sends the beneficiary a fax of the signed letter of credit – must the beneficiary present the signed original that it never received or may it present the fax or be excused from complying with the requirement?[28] Or suppose the issuer prints out a paper copy of the letter

[28] This was the situation in *LaBarge*. *See* 550 F.3d at 446–48. Barnes and Byrne commented that if the signed original, as opposed to the faxed copy, "is significant, it should be treated as belonging to the beneficiary and held by the issuer subject to the beneficiary's instructions, a topic not discussed in *LaBarge*." BARNES & BYRNE, *supra* note 11, at 1221.

of credit, signs it, and sends it to the beneficiary but it is lost in transit -- what then? A careful beneficiary should make sure that it is able to satisfy all the requirements of the letter of credit.

Still another scenario is where the beneficiary presents the original letter of credit for a partial drawing but the issuer fails to return the original letter of credit, perhaps because it was lost, stolen, mutilated, or destroyed while in the issuer's possession or while in transit back to the beneficiary or perhaps because the issuer is trying to prevent the beneficiary from drawing again. Presumably the issuer should not be allowed to enforce the requirement to present an original letter of credit where the issuer's actions have prevented the beneficiary from complying with the requirement.[29]

4. Accept the Requirement and Safeguard the Letter of Credit

Although it is not recommended, one option for the beneficiary is obviously to accept the requirement that it must present the original letter of credit, and then try its hardest to safeguard the original letter of credit. Fortunately for most beneficiaries, mishaps are relatively rare, and even where they occur the applicant may be obligated to cooperate with the beneficiary to enable it to obtain the payment supported by the letter of credit; of course, if the applicant is then insolvent or not on good terms with the issuing bank, the applicant may be unable to cause the issuing bank to pay the letter of credit and may be unable to pay the beneficiary itself or procure a replacement letter of credit.

Conclusion

ISP98 Rule 3.12(a) (Original Standby Lost, Stolen, Mutilated, or Destroyed) provides a valuable warning to beneficiaries and their counsel about the risks of conditioning the beneficiary's right to obtain payment, transfer drawing rights or assign letter of credit proceeds upon the presentation of the original letter of credit. Acquiescence to that condition may be tantamount to treating the original letter of credit like a magic talisman that must be safeguarded at all costs lest the beneficiary effectively lose its rights to obtain payment, transfer drawing rights, or assign letter of credit proceeds. That is a risk many beneficiaries should refuse to bear.

[29] *Cf.* U.C.C. § 3-504(a)(i) (2006) (presentment for payment of a negotiable instrument is excused if "the person entitled to present the instrument cannot with reasonable diligence make presentment.").

The Calm After the *Storm*? UCC Article 4A, *Jaldhi*, and the Future of Rule B Attachment in the Second Circuit

Adam D. Gold*

Introduction

At the heart of almost every major transaction in the commercial world is one party's obligation to send a payment to another party. The wholesale wire transfer system allows such parties to transfer extremely large sums of money across borders in an inexpensive and virtually insulated fashion.[1] Because of their central role in business transactions, wholesale wire transfers, a type of electronic funds transfer ("EFT"), represent the dominant payment system in the United States.[2] Using specialized software, banks provide wire transfer services to business and financial institutions in order to allow these entities to transfer such large sums of money at the speed of business.[3] In short, the wire transfer system is vital to the U.S. and world economies.

Considering the importance of the wire transfer system, the Uniform Commercial Code ("UCC") drafting committee created Article 4A in 1989 to establish a uniform and comprehensive source of law for funds transfers, and "better promote the use of funds transfers than would the existing patchwork rules developed by case law."[4] Today, every state in the United

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1 *See* RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS: CASES, MATERIALS, AND PROBLEMS 224 (4th ed. 2008).

2 *Id.* (measured by dollar volume).

3 *See* U.C.C. § 4A Prefatory Note, ¶ Description of transaction covered by Article 4A., ¶ Characteristics of a fund transfer. (1990).

4 Hyung J. Ahn, Note, *Article 4A of the Uniform Commercial Code: Dangers of Departing from a Rule of Exclusivity*, 85 VA. L. REV. 183, 188–89 (1999).

States has enacted Article 4A as law.[5] One important feature of Article 4A is that it was drafted to prevent litigants with claims against parties to funds transfers from capturing, impeding, or otherwise pulling funds back out of the wire transfer system, especially funds "held" by intermediary banks, a term discussed at length *infra*.[6] Yet, in *Winter Storm*, the United States Court of Appeals for the Second Circuit (the "Second Circuit") allowed litigants to use Rule B of the Federal Supplemental Rules for Certain Admiralty and Maritime Claims ("Rule B") to "capture" funds passing through New York City intermediary banks.[7] The court held that a sender's EFT that passes through a New York bank is legally vulnerable to a valid maritime attachment order.[8] Relying in part on Rule B, the court found that federal law preempted Article 4A.[9]

Several years of turmoil in the banking and legal communities followed this decision. Courts in the Southern District of New York ("SDNY") were inundated with Rule B claims.[10] New York City banks faced the logistical and financial nightmare of complying with a flood of daily attachment orders.[11] The ruling, if left unchecked, even might have threatened to undermine the U.S. dollar as the world's reserve currency.[12]

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[5] PERMANENT EDITORIAL BOARD FOR THE UNIF. COMMERCIAL CODE, PEB COMMENTARY NO. 16 SECTIONS 4A-502(d) and 4A-503 3 (2009) [hereinafter PEB].

[6] *See* U.C.C. § 4A-503 cmt. (1990); MANN, *supra* note 1, at 272.

[7] *See* Winter Storm Shipping, Ltd. v. TPI, 310 F.3d 263 (2d Cir. 2002), *overruled by* Shipping Corp. of India v. Jaldhi Overseas Pte Ltd., 585 F.3d 58 (2d Cir. 2009).

[8] *See id.* at 278.

[9] *See* Consub Del. LLC v. Schahin Engenharia Limitada, 543 F.3d 104, 109 (2d Cir. 2008) (citing Winter Storm Shipping Ltd. v. TPI, 310 F.3d 263 (2d Cir. 2002)), *abrogated by* Shipping Corp. of India v. Jaldhi Overseas Pte Ltd., 585 F.3d 58 (2d Cir. 2009); *see also* Aqua Stoli Shipping Ltd. v. Gardner Smith PTY Ltd., 460 F.3d 434, 438 (2d Cir. 2006).

[10] *See* PEB, *supra* note 5, at 5 n.4.

[11] *See* Brief for Amicus Curiae The Clearing House Ass'n LLC in Support of Defendant-Appellant at 10–11, Consub Del. LLC v. Schahin Engenharia Limitada, 543 F.3d 104 (2d Cir. 2008) (No. 07-0833-cv) [hereinafter Brief for Amicus Curiae The Clearing House Ass'n LLC].

[12] *See* Shipping Corp. of India v. Jaldhi Overseas Pte Ltd., 585 F.3d 58, 62 (2d Cir. 2009), *cert. denied,* 130 S. Ct. 1896 (2010).

Then, in late 2009, despite affirming the rule of *Winter Storm* several times previously,[13] the Second Circuit overruled *Winter Storm* in its unprecedented decision in *Shipping Corp. of India v. Jaldhi*.[14]

With *Jaldhi*, the Second Circuit moved its funds-transfer jurisprudence in the right direction. The opinion, however, failed to put a number of key issues to rest, which should be addressed by the Second Circuit in a subsequent decision in order to prevent the damage caused by *Winter Storm* from recurring.

This paper proceeds in three parts to analyze the *Winter Storm* ruling, the number of problems it created in its wake, and the *Jaldhi* opinion and its shortcomings. Part I provides background information regarding maritime attachment and discusses the mechanics of wire transfer transactions under Article 4A. Part II explores the *Winter Storm* rule, including the weakness in its legal reasoning and the profoundly negative consequences it had for the commercial world. Part III evaluates the *Jaldhi* decision and explores its weaknesses with respect to preventing the resurrection of *Winter Storm*-like reasoning.

I. Background Information

In order to understand the tumult created by *Winter Storm*, it is first necessary to examine maritime attachment under Rule B as well as the operation of Article 4A with respect to funds transfers.

A. Maritime Attachment Under Rule B

Under the Rules Enabling Act, 28 U.S.C. § 2073, the Supreme Court in 1966 established the Supplemental Rules for Certain Admiralty and Maritime Claims, "a reformed and comprehensive codification of admiralty rules to govern the practice of the federal courts."[15] Rule B, a jurisdictional rule included in the Supplemental Rules, governs the process by which a litigant may attach another party's assets in order to allow a district court to assert personal jurisdiction over the defendant whose property is attached. The rule provides in relevant part:

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13 *See Consub Del.*, 543 F.3d 104; *Aqua Stoli*, 460 F.3d 434.

14 *See Jaldhi,* 585 F.3d 58.

15 *Aqua Stoli*, 460 F.3d at 438.

> If a defendant is not found within the district . . . a verified complaint may contain a prayer for process to attach the defendant's tangible or intangible personal property—up to the amount sued for—in the hands of garnishees named in the process. . . . . The court must review the complaint and affidavit and, if the conditions of this Rule B appear to exist, enter an order so stating and authorizing process of attachment and garnishment.[16]

Rule B requires a plaintiff to establish four conditions before obtaining an attachment order from a court: (1) the plaintiff has a valid prima facie admiralty claim against the defendant, (2) the defendant cannot be found within the district, (3) the defendant's property may be found within the district, and (4) there is no statutory or maritime law bar to the attachment.[17] The jurisdiction conferred by a maritime attachment is characterized as *quasi in rem*—jurisdiction over a person but based on that person's interest in property that is located within the court's territory.[18]

The ease with which a plaintiff can obtain an attachment under Rule B process makes it an extremely strong tool for maritime plaintiffs.[19] In one sense, the maritime rules provide some procedural protection for defendants. Rule E(4)(f), for example, allows a defendant subject to an order of attachment under Rule B to appear before the district court to contest the attachment once its property has been restrained.[20] Yet, a plaintiff can obtain an attachment order from a district court *ex parte* and "without proving any of the merits of the underlying claim," which gives defendants little chance to prevent the attachment of their property before it is executed.[21] The historical rationales of maritime attachment help explain

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[16] *Id.* (quoting FED. R. CIV. P. SUPP. B(1)).

[17] *See id.* at 445.

[18] *Winter Storm*, 310 F.3d at 268.

[19] *See* Ian Taylor, Note, *Maritime Madness: Rule B, Electronic Funds Transfers, Maritime Contracts, and the Explosion of Admiralty Litigation in the Southern District of New York*, 34 TUL. MAR. L.J. 211, 220 (2009).

[20] *See Aqua Stoli*, 460 F.3d at 438.

[21] *See* Taylor, *supra* note 19, at 220.

the strong nature of this asset-attachment litigation tool. In *Aqua Stoli*, the Second Circuit wrote:

> Maritime attachments arose because it is frequently, but not always, more difficult to find property of parties to a maritime dispute than of parties to a traditional civil action. Maritime parties are peripatetic, and their assets are often transitory . . . . Thus, the traditional policy underlying maritime attachment has been to permit the attachments of assets wherever they can be found and not to require the plaintiff to scour the globe to find a proper forum for suit or property of the defendant sufficient to satisfy a judgment.[22]

The court has reiterated that maritime attachment serves two purposes: assuring the satisfaction of a successful suit and ensuring that elusive defendants appear in court.[23]

B. Mechanics of Wire Transfer Transactions Under Article 4A

1. Key Terms

Article 4A governs wire transfers, or EFTs whereby a party seeking to make a payment instructs his bank to push funds from his account into the account of his obligee.[24] It is important at the outset to identify several key terms in Article 4A. A "payment order" means "an instruction of a sender to a receiving bank . . . to pay, or to cause another bank to pay, a fixed or determinable amount of money to a beneficiary."[25] A "funds transfer," on the other hand, constitutes a *series* of payment orders, "beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order."[26] Furthermore, each entity that receives a payment order in a funds transfer is a "receiving bank" and

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[22] *Aqua Stoli*, 460 F.3d at 443.

[23] *See Winter Storm*, 310 F.3d at 268; Taylor, *supra* note 19, at 220.

[24] *See* U.C.C. § 4A Prefatory Note, ¶ Description of transaction covered by Article 4A. (1990).

[25] U.C.C. § 4A-103(a)(1) (1990).

[26] *Id.* § 4A-104(a).

each entity that sends a payment order in a funds transfer is a "sender."[27] "Originator" means the "sender of the first payment order in a funds transfer."[28] "Originator's bank" most usually means the "receiving bank to which the payment order of the originator is issued."[29] The "beneficiary's bank" is the "bank identified in a payment order . . . to make payment to the beneficiary" (in which an account of a beneficiary is to be credited).[30] Finally, the "intermediary bank" means a "receiving bank other than the originator's bank or the beneficiary's bank," which carries the payment order from the former to the latter.[31]

2. Concrete Illustration of Terms and Players in Action

Some simple illustrations are appropriate to identify the other key players and terms involved in a series of payment orders culminating in a funds transfer.[32] Suppose Mr. A transacts business with Mr. B and needs to pay Mr. B a large sum of money. Mr. A will begin the funds transfer by instructing his bank to debit his account and credit Mr. B's account.[33] Mr. A's instruction to his bank is a "payment order," Mr. A is the "originator" of the payment order, Mr. A's bank is the "originator's bank," and Mr. B is the beneficiary of the payment order.[34] Mr. A also is the "sender" because he instructed his bank to send the payment order. If Mr. A and Mr. B use the same bank, then Mr. A's bank is simultaneously the "originator's bank" and the "beneficiary's bank," such that the bank can carry out Mr. A's

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[27] *See id.* § 4A-103(a)(1), (4)-(5); § 4A-103(a)(4) (noting that only banks, and not people, can receive payment orders).

[28] *Id.* § 4A-104(c).

[29] *Id.* § 4A-104(d).

[30] *Id.* § 4A-103(a)(3).

[31] *Id.* § 4A-104(b).

[32] The following illustrations are based on the three lengthier hypothetical situations, Case No. 1, Case No. 2, and Case No. 3, presented in the Official Comment to U.C.C. Article 4A-104. *See* U.C.C. § 4A-104 cmt. 1 (1990).

[33] *See id.* § 4A-104 cmt. 1, Case No. 1.

[34] *See id.* § 4A-103(a)(1); § 4A-104(c); § 4A-104(d); § 4A-103(a)(2).

payment order by debiting and crediting the appropriate accounts without issuing another payment order.[35]

Due to a globalized economy, odds are high that Mr. A and Mr. B will use different banks.[36] If this is the case, Mr. A will send a payment order to his bank. His bank will then have two options. Under one option, Mr. A's bank will issue a subsequent and independent payment order directly to Mr. B's bank.[37] Mr. B's bank will then debit Mr. A's bank's account and credit Mr. B's account. In this case, Mr. B's bank is the "beneficiary's bank."[38] Thus, there are two different payment orders in this option: one from Mr. A to Mr. A's bank, and one from Mr. A's bank to Mr. B's bank.

Under a second option, Mr. A's bank will issue a subsequent and independent payment order to a third-party bank with whom it has a correspondent banking relationship.[39] The third-party bank will debit Mr. A's bank's account and credit its own account. Then, the third-party bank will issue a subsequent and independent payment order to Mr. B's bank. Mr. B's bank will debit the third-party bank's account and credit Mr. B's bank account, thereby completing the funds transfer. In this case, the third-party bank is an "intermediary bank."[40] Thus, there are three different payment orders in the second option: one from Mr. A to his bank, one from Mr. A's bank to the intermediary bank, and one from the intermediary bank to Mr. B's bank.[41]

[35] *See id.* § 4A-104(d); § 4A-103(a)(3). Assuming Mr. A's bank and Mr. B's bank are the same entity, Mr. A's bank would also be a "receiving bank" because it is the bank to which Mr. A's instruction is ultimately addressed. *See id.* § 4A-103(a)(4).

[36] *See id.* § 4A-104 cmt. 1, Case No. 2.

[37] *Id.*

[38] *See id.* § 4A-103(a)(3).

[39] *See id.* § 4A-104 cmt. 1, Case No. 3.

[40] *See id.* § 4A-104(b). In some cases, a funds transfer might be routed through several different intermediary banks. *See* U.C.C. § 4A Prefatory Note, ¶ Description of transaction covered by Article 4A. (1990).

[41] *Id.* § 4A-104 cmt. 1, Case No. 3.

In both options, each entity that sent a payment order was a "sender" and each bank that received a payment order was a "receiving bank."[42] Furthermore, the series of payment orders in either option, together, constitutes one funds transfer.[43] Thus, the original payment order from Mr. A to his bank is carried out by a series of payment orders by each bank in the transmission chain to the next bank in the chain until Mr. B's bank receives a payment order to make the credit to Mr. B's account.[44]

3. Acceptance and Execution of Payment Orders

The rights and obligations of an intermediary bank arise as the result of "acceptance" and "execution" of a payment order by the intermediary bank. Acceptance by an intermediary bank is governed by section 4A-209(a), which states in pertinent part: "Subject to subsection (d), a receiving bank other than the beneficiary's bank accepts a payment order when it executes the order."[45] Execution by an intermediary bank is governed by section 4A-301(a), which states in pertinent part: "A payment order is 'executed' by the receiving bank when it issues a payment order intended to carry out the payment order received by the bank."[46]

Reading sections 4A-209(a) and 4A-301(a) together reveals that an intermediary bank has discretion in determining whether to continue the transmission chain of an originator's payment order. An intermediary bank can reject, if it chooses, a payment order pursuant to section 4A-210(a).[47] If a bank properly rejects a payment order, it incurs no liability to the originator or to the beneficiary. The authoritative comment to section 4A-210 explains that "there are many reasons why a bank doesn't execute an order," including "equipment failure, credit limitations on the receiving bank, or some other factor which makes proper execution of the order

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[42] *See id.* § 4A-104 cmt. 1, Case No. 2 & Case No. 3.

[43] *Id.* § 4A-104 cmt. 1, Case No. 3.

[44] *See id.* § 4A-104 cmt. 1, Case No. 3; U.C.C. § Prefatory Note, ¶ Description of transaction covered by Article 4A. (1990).

[45] U.C.C. § 4A-209(a) (1990).

[46] *Id.* § 4A-301(a).

[47] *See id.* § 4A-210(a); *see also* § 4A-209 cmt. 8 (stating that acceptance is in the control of an intermediary bank and occurs only if the intermediary bank executes the payment order).

infeasible."[48] Furthermore, the authoritative comments to section 4A-209 make clear that a receiving bank has no duty to accept a payment order.[49]

If, however, the intermediary bank chooses to execute a payment order by issuing a subsequent payment order, it will be deemed to have "accepted" the payment order it received from the previous sender and will incur obligations and liabilities imposed by Article 4A.[50] One such obligation is that if the receiving bank to which the intermediary bank sent a payment order accepts the order, the intermediary bank becomes obligated to pay the receiving bank the amount of the intermediary's order.[51] This obligation may be excused, though, pursuant to Article 4A's "money back guarantee," which states that "[t]he obligation of [the] sender to pay its payment order is excused if the funds transfer is not completed by acceptance by the beneficiary's bank of a payment order instructing payment to the beneficiary of that sender's payment order."[52]

Properly understood, a funds transfer is essentially a series of independent contractual obligations between banks to carry out the instructions of the originator. The originator pays the beneficiary by causing the beneficiary's bank to become indebted to the beneficiary in the amount of the payment.[53] The debt arises when the beneficiary's bank accepts the payment order that the originator's bank, or an intermediary bank, issued to the beneficiary's bank to execute the originator's order.[54] The drafters of Article 4A specified that "[a]lthough Article 4A follows convention in using the term 'funds transfer' to identify" a payment from the originator to the beneficiary, "no money or property right" of the originator is actually transferred to the beneficiary.[55]

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[48] *Id.* § 4A-210 cmt. 1.

[49] *See id.* § 4A-209 cmt. 1.

[50] *See, e.g.*, *id.* § 4A-302; § 4A-303; § 4A-305; § 4A-402.

[51] *See id.* § 4A-402(c); § 4A-402 cmt. 2.

[52] *Id.* § 4A-402(c); § 4A-402 cmt. 2.

[53] *See* U.C.C. § 4A Prefatory Note, ¶ Description of transaction covered by Article 4A., ¶ Concept of acceptance and effect of acceptance by the beneficiary's bank. (1990).

[54] *See id.*

[55] *See id.* ¶ Concept of acceptance and effect of acceptance by the beneficiary's bank.

II. The Road to *Jaldhi*

Since the Second Circuit relied upon *United States v. Daccarett* to support its holding in *Winter Storm*, Part II begins with a brief exposition of *Daccarett* as a starting point for the discussion of case law and developments leading up to *Jaldhi*. Part II then presents the statement of the case for *Winter Storm* and discusses its shortcomings as a matter of law. Finally, it addresses the collateral damage that *Winter Storm* inflicted on legal and commercial entities.

A. *Daccarett* – Key Case for *Winter Storm* Decision

Daccarett was a criminal case arising out of an international effort to impede the drug-trafficking and money-laundering activities of the Cali Cartel, a Colombian drug cartel headed by Jose Santacruz-Londono.[56] The Cartel used EFTs to move its drug proceeds around the world for ultimate disposition into Colombian bank accounts.[57] In an attempt to stop the flow of illicit money back to drug suppliers, Congress enacted several statutes aimed at inhibiting drug-trafficking and money-laundering activities. At issue in the case was one such statute, 18 U.S.C. § 981, which allows the U.S. Government to institute civil forfeiture proceedings against any *property* involved in the drug offense without first obtaining a conviction.[58] The U.S. Government, relying on § 981, seized approximately $12 million by intercepting and attaching dozens of EFTs sent through New York City intermediary banks that had correspondent banking relationships with the Cartel's banks in Panama and Colombia.[59]

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[56] United States v. Daccarett, 6 F.3d 37, 43 (2d Cir. 1993) (noting that the Colombian conglomerate was alleged to have imported approximately 3,000 kgs of cocaine per month into the United States).

[57] *Id.*

[58] *See id.* (emphasis added).

[59] *Id.* at 44 ("[T]rough both oral orders and a series of eight arrest warrants *in rem*, government agents instructed the intermediary banks in New York to attach 'all funds' on deposit in the names of various individuals and entities connected with Santacruz-Londono and 'all related entities and individuals', and to inform the agents about all transfers that were destined for a third-party beneficiary in Colombia. The intermediary banks complied with the agents' directions; they initially froze the seized funds and later transferred them to the clerk of the court who now holds them pending the outcome of this appeal.").

The Court faced the issue of whether EFTs held by intermediary banks were subject to civil forfeiture under § 981.[60] In ultimately what became a significant basis for the court's subsequent decision in *Winter Storm*, the Second Circuit laid out its conception of EFTs as they move through the chain of transmission between banks. The court wrote that

> [t]he claimants' conception of the intermediary banks as messengers who never hold the goods, but only pass the word along, is inaccurate. On receipt of EFTs from the originating banks, the intermediary banks possess the funds, in the form of bank credits, for some period of time before transferring them on to the destination banks. While claimants would have us believe that modern technology moved the funds from the originating bank through the intermediary bank to their ultimate destination without stopping, that was not the case. With each EFT at least two separate transactions occurred: first, funds moved from the originating bank to the intermediary bank; then the intermediary bank was to transfer the funds to the destination bank, a correspondent bank in Colombia. While the two transactions can occur almost instantaneously, sometimes they are separated by several days. Each of the amounts at issue was seized at the intermediary bank after the first transaction had concluded and before the second had begun.[61]

The court held that "an EFT while it takes the form of a bank credit at an intermediary bank is clearly a seizable *res* under the forfeiture statutes."[62] It explained that civil forfeiture perpetuates "the legal fiction that 'property used in violation of [the] law was itself the wrongdoer that must be held to account for the harms'" it has caused.[63] Thus, a precedent had been set by the court that—at least in civil forfeiture cases—an EFT is attachable *property*.

[60] *Id.* at 43.

[61] *Id.* at 54.

[62] *Id.* at 55.

[63] *Id.* at 45–46.

B. *Winter Storm* Rule

Almost a decade later, the Second Circuit revisited its holding in *Daccarett* in *Winter Storm Shipping v. TPI*.[64] The case arose after Winter Storm Shipping, a Maltese corporation, chartered its vessel to TPI, a Thai corporation.[65] Winter Storm claimed that TPI breached the terms of the charter and brought a maritime claim in the SDNY so it could invoke the court's admiralty jurisdiction under 28 U.S.C. § 1333.[66] It further alleged that TPI could not be "found within" the SDNY under Rule B and sought an order of attachment to be sent to "Chase Manhattan Bank and/or Bank of New York" as potential garnishees[67]—institutions that are "indebted to . . . another whose property has been subjected to garnishment."[68] The district court issued the order of attachment *ex parte* and the specified banks were served with process. At the time of service, Bank of New York ("BNY") held no funds of TPI, but it placed a stop order on any funds relating to TPI that might pass through its New York City branch.[69]

While the proceedings took place in New York City, "TPI entered into an unrelated commercial transaction with Oppsal Shipping Co., Ltd."[70] The terms of the contract called for TPI to pay Oppsal in U.S. dollars. To satisfy this provision, TPI instructed its bank, Bank of Ayudhya ("BA"), to send a wire transfer through BNY as an intermediary bank to Oppsal's bank, the Royal Bank of Scotland ("RBS").[71] On July 2, 2001, BNY received from BA a payment order in the amount of $1,085,071.41. Rather than accepting and executing BA's entire payment order, BNY issued a payment order to RBS in the amount of $723,449.83. Pursuant to the earlier service of attachment procured by Winter Storm in the SDNY, BNY put the

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[64] *See Winter Storm*, 310 F.3d at 276–77.

[65] *Id.* at 265.

[66] *Id.*

[67] *Id.* at 266.

[68] BLACK'S LAW DICTIONARY 702 (8th ed. 2004).

[69] *Winter Storm*, 310 F.3d at 266.

[70] *Id.* at 267.

[71] *Id.* at 266.

balance of the payment order, $361,621.58, into a suspense account because it represented the total amount of Winter Storm's claims against TPI.[72]

TPI subsequently challenged the validity of the attachment order in the SDNY. Judge Scheindlin held that an EFT intercepted at an intermediary bank is not "property" that can be attached under Admiralty Rule B.[73] Thus, the issue of whether EFTs are attachable property under Rule B was "teed-up" for the Second Circuit.

That court wasted no time in reversing Judge Scheindlin and held that EFT funds in the hands of an intermediary bank may be attached pursuant to Rule B.[74] Notably, the *Winter Storm* rule became the source of anxiety and chaos which engulfed the SDNY until the recent *Jaldhi* decision.

The court began by dismissing any notion that Rule B violated a garnishee's due process rights. Though TPI argued that it had no contacts with the district, had no expectation that its funds would be routed momentarily through a New York City bank, and otherwise had no reason to believe it would be hailed into a court in New York, the Court found that the procedural safe guards in Rule B and Rule E, discussed *supra*, were adequate to protect a garnishee's rights.[75]

The court next turned to the issue of whether TPI's funds in the hands of BNY during the funds transfer constituted "property" of TPI for the purposes of Rule B. Judge Haight, sitting by designation, noted that federal law generally governs questions as to the validity of Rule B attachments and "state law may be borrowed if there is no federal admiralty law" on point.[76] Despite broaching the topic of state law, the court relied exclusively on federal sources to "fashion a rule . . . that EFT funds in the hands of an intermediary bank may be attached pursuant to Admiralty Rule B(1)(a)."[77]

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[72] *Id.* at 266–67.

[73] *Id.* at 267.

[74] *Id.* at 278.

[75] *Id.* at 273.

[76] *See Winter Storm,* 310 F.3d at 275–76.

[77] *See id.* at 278.

In particular, the court relied on the three main sources of federal support for the *Winter Storm* rule. First, it noted "that federal admiralty law regards a defendant's bank account as property subject to maritime attachment under Rule B."[78] Second, perceiving a close relationship between a bank account and an EFT sent from a bank account, it interpreted the language of Rule B extremely broadly. Referring to the text of the rule, it explained that "[i]t is difficult to imagine words more broadly inclusive than tangible or intangible" and found that an EFT in the hands of an intermediary bank falls within the rule's ambit as property of the defendant.[79] Third, it found "significant guidance" in *Daccarett*.[80] Noting the *Daccarett* rule that "an EFT while it takes the form of a bank credit at an intermediary bank is clearly a seizable *res* under the forfeiture statutes," it wrote that "[t]here is no principled basis for applying a different analysis or arriving at a different conclusion in the instant case."[81]

Having found that the rule it fashioned derived from federal law, the court found state law was preempted to the extent that it would hold that an EFT in the hands of an intermediary bank is not seizable property under Rule B.[82] After briefly acknowledging Article 4A, the court found that the equitable interests of maritime plaintiffs in having access to Rule B attachment presented no occasion to reject the federal rule in favor of Article 4A's prescriptions.[83]

C. Problems with the Rule of *Winter Storm*

Almost immediately, courts, banks, commentators, and the legal community generally took issue with *Winter Storm*. This section explores different weaknesses of the Second Circuit's reasoning in *Winter Storm* and then addresses negative repercussions of the *Winter Storm* rule.

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[78] *Id.* at 276–77.

[79] *See id.* at 276.

[80] *Id.*

[81] *Id.* at 278.

[82] *See id.* at 278–79.

[83] *See Winter Storm,* 310 F.3d at 279–80.

1. *Winter Storm's* Misplaced Reliance on *Daccarett*

One of the biggest problems with *Winter Storm* is that the Second Circuit incorrectly based its holding on a civil forfeiture *in rem* remedy, which was not relevant to deciding whether an EFT in the hands of an intermediary bank is attachable property under Rule B. The Permanent Editorial Board for the Uniform Commercial Code (the "PEB") suggested that the Second Circuit's reliance on *Daccarett* for the rule of *Winter Storm* was misplaced.[84] The key, according to the PEB, is distinguishing between civil forfeiture and a remedy *quasi in rem*. Specifically, as a remedy *quasi in rem*, the validity of a Rule B attachment depends entirely on the determination that the *res* at issue is property of the judgment-debtor at the moment it is attached.[85] "Forfeiture, on the other hand, is a remedy *in rem*, based . . . on the legal fiction that 'property used in violation of law [is] itself the wrongdoer that must be held to account for the harms it [has] caused.'"[86] The *Winter Storm* court failed to note that *Daccarett*, a forfeiture action under the federal drug laws, did not address whether the obligations created by an EFT are property of either the originator or the beneficiary of a funds transfer. That issue, although determinative in *Winter Storm*, was irrelevant under the forfeiture statutes because the funds subject to attachment were the property of the government under the legal fiction noted *supra*.[87]

While the Second Circuit thought this distinction was immaterial, the difference between civil forfeiture and a remedy *quasi in rem* makes all of the difference in determining whether EFTs are attachable property while they are briefly held by intermediary banks. One element of a plaintiff's prima facie case for Rule B attachment is that it must prove the funds it seeks to attach are the "property" of the defendant. Since *Daccarett* did not have cause to address whether an originator or beneficiary of an EFT has a

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[84] PEB, *supra* note 5, at 4–5 n.3.

[85] *Id.* at 5 n.3 (citing J. Lauritzen A/S v. Dashwood Shipping, Ltd., 65 F.3d 139, 141 (9th Cir. 1995) (characterizing Rule B attachment as *quasi in rem* jurisdiction "because jurisdiction is derived solely from the attachment of the property of the defendant.")).

[86] *Id.* (explaining that there is a critical distinction between actions proceeding under Supplemental Rule C—now Rule G—and those brought under Rule B; it is not a "distinction without a difference," as *Winter Storm* found).

[87] *See Consub Del.*, 543 F.3d 104; Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 4; *see also* Daccarett, 6 F.3d at 45–46.

property interest in such EFT, that case cannot form a basis for holding that Second Circuit precedent requires a court to find that funds held by an intermediary bank in the chain of a wire transfer transmission are property of the originator or beneficiary. After all, the fact that the government can seize proceeds at any bank as long as there is some "traceable connection to an illegal transaction in controlled substances" sheds little light on whether an EFT is property under maritime law.[88] The Federal Reserve Bank of New York agreed that "by extending the definition of property used in *Daccarett*, a criminal case involving the proceeds of unlawful narcotics trafficking, to the commercial realm of maritime attachments, the *Winter Storm* court created a crack in the legal infrastructure underlying the U.S. payments system."[89]

Once *Daccarett* is removed as an independent source of federal support, *Winter Storm's* holding that Article 4A is preempted by federal law becomes untenable. Rule B confers jurisdiction on a district court by allowing a litigant to attach a party's property such that the property becomes the basis for the court's assertion of personal jurisdiction over that party. Properly understood, Rule B is a jurisdictional statute that does not define what "property" is.[90] Despite the broad language used in Rule B, which the *Winter Storm* court found significant, the rule does not offer guidance on whether an EFT passing through an intermediary bank is property of an originator or beneficiary. Since there was no federal rule on point, the Second Circuit should have looked to state law, specifically New York's Article 4A, to define the term "property."[91]

A closer inspection, however, reveals that there is no divergence between federal and state law treatment of EFTs passing through intermediary banks. First, federal law has explicitly incorporated Article 4A to define rights and obligations of parties to a funds transfer through the

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[88] Brief for Amicus Curiae Federal Reserve Bank of New York in Support of Defendant-Appellant at 8–9, Consub Del. LLC v. Schahin Engenharia Limitada, 543 F.3d 104 (2d Cir. 2008) (No. 07-0833-cv) (quoting Winter Storm Shipping, Ltd. v. TPI, 198 F. Supp. 2d 385, 388–89 (S.D.N.Y. 2002), *vacated*, 310 F.3d 263, 280 (2d Cir. 2002)) [hereinafter Brief for Amicus Curiae Federal Reserve Bank of New York].

[89] *See id.* at 17.

[90] *See* PEB, *supra* note 5, at 3.

[91] *See Aqua Stoli*, 460 F.3d at 445 n. 6.

adoption of Regulation J, 12 C.F.R. 210.25–210.32 ("Reg J").[92] Reg J incorporates Article 4A to cover all funds transfers conducted on the "Fedwire" funds transfer system. In keeping with the Federal Reserve Banks' role as payments system operators, the Federal Reserve Banks own and operate the Fedwire system, which is the "dominant system for transfers between U.S. banks."[93] The Federal Reserve Banks both originate funds transfers and act as receiving banks—either an intermediary bank or the beneficiary's bank—for each of the transfers that is sent over the Fedwire system.[94] Statutory interpretation dictates that the definition of property vis-à-vis Rule B attachment actions regarding EFTs sent via the Fedwire system is governed by state law pursuant to § 210.25(b).[95]

What about EFTs that are not sent via the Fedwire system, specifically EFTs sent across international borders? The Clearing House Interbank Payments System ("CHIPS") network, owned and operated by the New York Clearing House Association, handles 95% of the international transfers made in dollars, transferring an average of $750 billion per day.[96] These funds are transferred through participating banks located in New York because all of the banks belonging to the CHIPS network must maintain a regulated presence in New York. As a result, NewYork is considered the national and international center for wholesale wire transfers.[97] Reg J does not on its face incorporate Article 4A to govern CHIPS transfers because the regulation only refers to governing collections by Federal Reserve Banks and Fedwire funds transfers.[98] Yet, courts should look to Reg J for guidance for the sake of uniformity and efficiency of international commercial business interests. It surely does not make sense

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[92] *See* Regions Bank v. Provident Bank, Inc., 345 F.3d 1267, 1274 (11th Cir. 2003); 12 C.F.R. § 210.25(b) (2010); Brief for Amicus Curiae Federal Reserve Bank of New York, *supra* note 88, at 4 (noting that for transfers processed over Fedwire, the Federal Reserve has adopted Article 4A as federal law in its Regulation J).

[93] MANN, *supra* note 1, at 237.

[94] *Id.* at 3.

[95] *See* Thomas C. Baxter & Raj Bhala, *The Interrelationship of Article 4A with Other Law*, 45 BUS. LAW. 1485 (1990).

[96] Banque Worms v. BankAmerica Int'l, 570 N.E.2d 189, 194 & n.2 (N.Y. 1991).

[97] *Id.*

[98] *See* 12 C.F.R. §§ 210.1, 210.25(a), (b) (2010).

that federal courts are required to apply New York law to Fedwire transactions via Reg J but are free to fashion a wholly different rule to govern CHIPS transactions, especially because international business transactions can rely on both systems.

Indeed, the policy behind Article 4A and Reg J dictates that the Second Circuit should look to Article 4A, a body of law enacted in every state and by the federal government for Fedwire transactions, to govern CHIPS transactions during the time they pass through the United States. A goal of the Federal Reserve in adopting Article 4A, as federal law through Reg J, was to encourage uniformity and certainty in the law applicable to all funds transfers.[99] The Clearing House Association LLC asserted that federal courts should give deference to Article 4A because it is consistent both with federal law and the laws in all fifty-two jurisdictions that have adopted the UCC.[100] This is especially persuasive because the dominant interest in drafting Article 4A was uniformity due to the "inherently interjurisdictional nature of funds transactions."[101] In fact, the New York Court of Appeals, the highest authority on the application of New York law, has long held that "national uniformity in the treatment of electronic funds transfers [(EFTs)] is an important goal, as are speed, efficiency, certainty, and finality."[102] Domestic banks should enjoy certainty of knowing that the integrity of their intermediary payment order obligations will not vary depending upon the domestic or international character of the individual funds transfer.

Considering the inapplicability of *Daccarett* and the goals of uniformity and certainty in funds transfer transactions, there was no basis for the *Winter Storm* court to find that federal maritime law in the form of Rule B preempted Article 4A in determining the property rights and obligations of the defendant-originator in that case. Since Rule B offers no guidance on whether an EFT passing through an intermediary bank is property of an originator or beneficiary, Rule B is not such a superseding law.[103]

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[99] Brief for Amicus Curiae Federal Reserve Bank of New York, *supra* note 88, at 14–15.

[100] Brief for Amicus Curiae The Clearing House Ass'n, *supra* note 11, at 17.

[101] Ahn, *supra* note 4, at 188–89.

[102] *See Banque Worms*, 570 N.E.2d at 195.

[103] PEB, *supra* note 3, at 3, 5.

2. The *Winter Storm* Court Fashioned a Rule Wholly at Odds with Article 4A's Treatment of Funds in Intermediary Banks

Had the *Winter Storm* court relied upon New York's Article 4A laws, it certainly would have arrived at a different result. In fact, the court fashioned a rule that was wholly at odds with Article 4A's recognition that funds held temporarily by an intermediary bank during a funds transfer are not property of either the originator or the beneficiary.[104]

To obtain attachment under Rule B, the party seeking attachment must show that the property to be attached is in fact owned by the party against whom attachment is sought. Yet, Article 4A explicitly and directly commands that an intermediary bank holds no property of either the originator or the beneficiary.[105] The PEB succinctly explained the underpinnings of Article 4A's stance on the status of funds in intermediary banks involved in an EFT:

> [U]nder the Article 4A structure, the issuance and acceptance of payment orders create rights and obligations only as between the sender of the payment order and its receiving bank (e.g., between originator and originator's bank as to the originator's payment order), between the originator's bank and an intermediary bank as to the originator's bank's payment order, between the intermediary bank and the beneficiary bank as to the intermediary bank's payment order, and finally as between the beneficiary bank that has accepted a payment order and the beneficiary. Accepted and executed payment orders thus create contractual obligations that result in a series of credits and debits to bank accounts. They do not involve a transfer of property of the originator to the beneficiary. A receiving bank owes its contractual obligation to its sender to execute the payment order and the sender owes its contractual obligation to pay the amount of the payment order to its receiving bank. The intermediary

[104] *See Jaldhi*, 585 F.3d at 71; U.C.C. § 4A-502 cmt. 4 (1990) (showing that funds held temporarily during a funds transfer are not property of the originator or the beneficiary); Brief for Amicus Curiae Federal Reserve Bank of New York, *supra* note 88, at 2 (showing that the U.C.C., as adopted by the federal and state governments, governs Fedwire transactions).

[105] *See Jaldhi*, 585 F.3d at 71; U.C.C. § 4A Prefatory Note, ¶ Concept of acceptance and effect of acceptance by the beneficiary's bank. (1990); PEB, *supra* note 5, at 3.

> bank has no contractual obligation to the originator or to the beneficiary, and neither the originator nor the beneficiary has any contractual obligation to or rights flowing from the intermediary bank. Thus, credits in an intermediary bank are credits in favor of the originator's bank, *and are not property of either the originator or the beneficiary*.[106]

The PEB's reasoning is grounded in the distinction between payment orders and funds transfers with regard to the issue of privity of contract. While a funds transfer is the cumulative process of sending a series of payment orders, parties to a funds transfer are only in privity with their immediate transferor and their immediate transferee.[107] An intermediary bank, while in privity with an originator's bank and a beneficiary's bank, has no direct connection either to an originator or a beneficiary.[108] Because of this fact, the PEB explains that neither the originator nor the beneficiary has an interest in the funds held by an intermediary bank because they do not have contractual rights to compel the bank to continue the transfer or cause the bank to pay them directly.[109]

To better understand this concept, I revisit the illustration in Part I. In the illustration, Mr. A seeks to send an EFT to Mr. B in order to satisfy a business debt he owes to Mr. B. Mr. A begins the funds transfer by issuing a payment order to his bank, the originator's bank. As soon as the originator's bank accepts Mr. A's payment order by executing a subsequent payment order to an intermediary bank, Mr. A owes the originator's bank an obligation to pay the amount of the payment order.[110] As soon as the intermediary bank accepts the originator's bank's payment order by executing a payment order to Mr. B's bank, the beneficiary's bank, the originator's bank owes the intermediary bank an obligation to pay the amount of the payment order.[111] Finally, as soon as the beneficiary's bank accepts the intermediary bank's payment order pursuant to 4A-209(b), the

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[106] PEB, *supra* note 5, at 2 (emphasis added).

[107] *See id.* at 1–2.

[108] *See id.* at 2.

[109] *See id.* at 2–3.

[110] *See* U.C.C. § 4A-402(c) (1990).

[111] *See id.*

intermediary owes the beneficiary's bank an obligation to pay the amount of the payment order.[112]

A funds transfer, or the accumulation of payment orders allowing Mr. A to pay Mr. B, is essentially a "series of payment orders that create contractual obligations *only* as to the sender and receiver of each payment order"—contractual obligations which are not the property of either the originator or the beneficiary.[113] The Second Circuit recognized this principle in *Grain Traders*, where the Court precluded an originator of a funds transfer from suing an intermediary bank.[114] Because the originator is in contractual privity only with the originator's bank,[115] the originator has no claim or property right as against an intermediary bank.

The logical implication of Article 4A precluding originators and beneficiaries from claiming a property right to funds held by intermediary banks is that neither the creditor of an originator nor a beneficiary properly may issue creditor process seeking to attach EFTs held by an intermediary bank because such bank does not hold property of either the originator or the beneficiary.[116] Thus, a payment order held by an intermediary bank cannot be thought of as "property" of either the originator or the beneficiary.

The Federal Reserve Bank of New York explained that the policy behind the rule that the originator is in contractual privity only with the originator's bank and, thus, has no has no claim or property right against an intermediary bank, is fundamental to commercial law.[117] It stated that "[c]ommercial parties should not be expected to look beyond pre-existing contractual relationships that anticipate and allocate risk. It is this concept, contractual privity, that provides the necessary certainty to the payments

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[112] *See id.* § 4A-209 cmt. 4; § 4A-404(a).

[113] PEB, *supra* note 5, at 1 (emphasis added).

[114] *Id.* at 4 n.3 (citing Grain Traders, Inc. v. Citibank, N.A., 160 F.3d 97 (2d Cir. 1998)).

[115] *See id*. at 2.

[116] *See* PEB, *supra* note 5, at 3; Brief for Amicus Curiae Federal Reserve Bank of New York, *supra* note 88, at 13–14.

[117] *See* Brief for Amicus Curiae Federal Reserve Bank of New York, *supra* note 88, at 15–16.

system."[118] Indeed, Article 4A explicitly recognizes that the creditor's right to attach the originator's funds hinges on the existence of privity between the two parties. Section 4A-502 governs creditor process served on a receiving bank.[119] Comment four to this section states that a creditor may want to reach funds involved in a funds transfer, including serving process on an intermediary bank.[120] Subsection (d) is intended to guide creditors and courts "as to the proper method of reaching the funds involved in a funds transfer." Pursuant to this subsection, "a creditor of the originator can levy on the account of the originator . . . before the funds transfer is initiated, but . . . cannot reach any other funds because no property of the

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[118] *Id.* at 15.

[119] That provision reads:

> (a) As used in this section, "creditor process" means levy, attachment, garnishment, notice of lien, sequestration, or similar process issued by or on behalf of a creditor or other claimant with respect to an account. (b) This subsection applies to creditor process with respect to an authorized account of the sender of a payment order if the creditor process is served on the receiving bank. For the purpose of determining rights with respect to the creditor process, if the receiving bank accepts the payment order the balance in the authorized account is deemed to be reduced by the amount of the payment order to the extent the bank did not otherwise receive payment of the order, unless the creditor process is served at a time and in a manner affording the bank a reasonable opportunity to act on it before the bank accepts the payment order. (c) If a beneficiary's bank has received a payment order for payment to the beneficiary's account in the bank, the following rules apply: (1) The bank may credit the beneficiary's account. The amount credited may be set off against an obligation owed by the beneficiary to the bank or may be applied to satisfy creditor process served on the bank with respect to the account; (2) The bank may credit the beneficiary's account and allow withdrawal of the amount credited unless creditor process with respect to the account is served at a time and in a manner affording the bank a reasonable opportunity to act to prevent withdrawal; (3) If creditor process with respect to the beneficiary's account has been served and the bank has had a reasonable opportunity to act on it, the bank may not reject the payment order except for a reason unrelated to the service of process. (d) Creditor process with respect to a payment by the originator to the beneficiary pursuant to a funds transfer may be served only on the beneficiary's bank with respect to the debt owed by that bank to the beneficiary. Any other bank served with the creditor process is not obliged to act with respect to the process.

U.C.C. § 4A-502 (1990).

[120] *Id.* § 4A-502 cmt. 4.

originator is being transferred."[121] A creditor of the beneficiary can serve process only on the beneficiary's bank to reach the obligation of the beneficiary's bank to pay the beneficiary, *but only after* the beneficiary's bank has accepted the transfer—before this point the beneficiary has no property interest in the funds.[122] Section 4A-503 solidifies the principle that intermediary banks are insulated entities under Article 4A as it serves as a prohibition on injunctions and restraining orders with respect to funds transfers. This section states:

> For proper cause and in compliance with applicable law, a court may restrain (i) a person from issuing a payment order to initiate a funds transfer, (ii) an originator's bank from executing the payment order of the originator, or (iii) the beneficiary's bank from releasing funds to the beneficiary or the beneficiary from withdrawing the funds. A court may *not* otherwise restrain a person from issuing a payment order, paying or receiving payment of a payment order, or otherwise acting with respect to a funds transfer.[123]

The authoritative comment to this section explains that section 4A-503's prohibitions are designed to prevent the interruption of a funds transfer after it has been set in motion.[124] Most importantly, the drafters explained that a creditor can enjoin an originator's bank from initiating a payment order and a beneficiary's bank from paying the beneficiary, but "[n]o other injunction is permitted. *In particular, intermediary banks are protected* . . . ."[125]

In addition to Article 4A's explicit prohibitions on interrupting the transmission chain of a funds transfer, the drafters crafted other provisions to insulate the wire transfer system from interruption. For example, comment four to section 4A-211, which governs the rejection of a payment order, states that it is not appropriate to allow the beneficiary's bank to

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[121] *See id.*

[122] *See id.*; Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 6–7 n.5.

[123] U.C.C. § 4A-503 (1990) (emphasis added).

[124] *Id.* § 4A-503 cmt. (noting that this section is related to § 4A-502(d) and U.C.C. § 4A-502 cmt.4).

[125] *Id.* § 4A-503 cmt. (emphasis added).

cancel or amend a payment order except in "unusual circumstances."[126] In addition, section 4A-211 places strong limitations on an originator's ability to cancel or amend his payment order.[127] Moreover, a beneficiary's bank can ignore an originator's request for cancellation since the originator is not the sender of the payment order to the beneficiary's bank.[128] Taken together, these provisions show the drafters intended that a payment order sent by an originator is designed to be virtually irrevocable and insulated until the time it reaches the beneficiary's bank account, except in certain stated cases of error.

Thus, the rule fashioned by the *Winter Storm* court that EFT funds in the hands of an intermediary bank may be attached pursuant to Rule B, is contrary to Article 4A's command that funds held by an intermediary bank in the form of a payment order are not the property of an originator or beneficiary and are not subject to an injunction, a temporary restraining order, or attachment.

3. *Winter Storm's* Rule Inflicted Collateral Damage on the Commercial World.

a. Article 4A Interests

One of the biggest criticisms of the *Winter Storm* rule is that it seemed to ignore the collateral damage it would cause to the commercial world by disrupting the careful balance of interests created by Article 4A. Article 4A created a specialized body of law to create a high-speed, efficient, and low-cost payment system.[129] The drafters of Article 4A made a deliberate decision to use precise and detailed rules to "assign responsibility, define behavioral norms, allocate risks and establish limits on liability, rather than to rely on broadly stated, flexible principles."[130] A critical consideration in drafting the rules "was that the various parties to funds transfers need to be able to predict risk with certainty, to insure

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[126] *See* § 4A-210 cmt. 3.

[127] *See id.* § 4A-211.

[128] *See id.* § 4A-404 cmt. 3.

[129] *See Banque Worms*, 570 N.E.2d at 195; U.C.C. § 4A Prefatory Note, ¶ Why is Article 4A needed? (1990).

[130] U.C.C. § 4A-102 cmt. (1990).

against risk, to adjust operational and security procedures, and to price funds transfer services appropriately."[131] The official comment to section 4A-102 states that:

> Funds transfers involve competing interests—those of the banks that provide funds transfer services and the commercial and financial organizations that use the services, as well as the public interest. These competing interests were represented in the drafting process and they were thoroughly considered. The rules that emerged represent a careful and delicate balancing of those interests and are intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by particular provisions of the Article.[132]

It seems that the *Winter Storm* court disregarded these sentiments. By departing from the delicate balance of interests achieved through the Article 4A drafting process, the court created much havoc in the legal and banking worlds.

b. The Courts

Regarding *Winter Storm's* unintended consequences for the judiciary, the SDNY saw an increasing number of actions for maritime attachment under Rule B filed each year after the *Winter Storm* rule was first announced. The logistical nightmare for court dockets reached unprecedented levels in the time immediately before the *Jaldhi* decision was handed down. For example, of the approximately 10,600 lawsuits filed in the SDNY in 2008, "just over 2000 constituted claims resulting from alleged breaches of maritime contracts."[133] In addition, "from October 1, 2008, to January 31, 2009, maritime plaintiffs filed 962 lawsuits seeking to attach more than $1.35 billion."[134] These attachment lawsuits "constituted 33 percent of all lawsuits filed in the Southern District of New York during that period."[135] Similarly, one district court estimated that maritime

[131] *Id.*

[132] *Id.*

[133] Taylor, *supra* note 19, at 216.

[134] PEB, *supra* note 5, at 5 n.4.

[135] *Id.*

attachment requests in the SDNY would comprise approximately one-third of all cases filed in 2009.[136]

c. The Banks

Courts were not the only entities feeling the wrath of *Winter Storm*. Banks located in New York City faced a logistical and financial nightmare dealing with the inundation of service of process resulting from Rule B suits instituted in the SDNY. Noting several startling attachment statistics, the Clearing House Association LLC explained that the consequences of Winter Storm for NYC banks were drastic. In February 2006, Citibank "had pending 70 active writs of maritime attachment, seeking to attach over $195 million. JP Morgan Chase Bank was served with an average of 138 writs of maritime attachment *per day* during a week in June 2007."[137] Wachovia Bank was "served in 2007 with an average of 210 writs per day, seeking attachment of over $500 million."[138] UBS "was served with 272 writs per week in June 2007, and the aggregate dollar amount of active writs at UBS" by August 2007 exceeded $267 million.[139] Looking at single day statistics paints an even starker picture. For example, "on July 16, 2007, The Bank of New York received 209 writs seeking to attach $528 million."[140] Similarly, "[o]n July 19, 2007, Deutsche Bank was served with 161 writs, and Bank of America was served with 209 seeking attachment of nearly $495 million."[141]

The volume of maritime attachment orders placed a monumental burden on banks' daily operations. One of the most significant problems they encountered was that the only practical way in which they could effectuate all of the attachment orders was to make frequent amendments to their software screens that list entities and other persons whose financial

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[136] *See* Cala Rosa Marine Co. Ltd. v. Sucres et Deneres Group, 613 F. Supp. 2d 426, 431–32 n.37 (S.D.N.Y. 2009).

[137] Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 7.

[138] *Id.*

[139] *Id.*

[140] *Id.*

[141] *Id.*

transactions must be blocked.[142] As the Clearing House Association explained in its amicus curiae, "[t]he process of constantly amending software screens to deal with this flood of maritime attachments greatly increased the number of 'hits,' including numerous false hits, that the screens generated, creating real risks of inefficiency and error in the day-to-day processing of funds-transfer payment orders."[143] As a consequence of the deluge of attachment orders, New York banks were forced to hire additional staff and suffered considerable expenses to process such attachments.[144]

d. The U.S. Dollar and New York City as a World Financial Center

This large volume of attachment orders presented a greater danger than merely inhibiting the efficient functioning of daily banking operations. *Winter Storm* threatened to compromise the role of the U.S. Dollar as the world's primary reserve currency and New York City's standing as a center of international funds transfers.[145] Before *Jaldhi*, the PEB warned that companies around the world might begin restructuring their transactions to provide for payments in euros, sterling, yen, or some other currency to avoid using U.S. dollars cleared through intermediary banks in the United States, or, alternatively, clear transactions through one of the proliferating off-shore dollar clearing networks.[146] Because the only contact with the United States in most of these transactions is the use of an intermediary bank in New York City to clear U.S. dollars, costly Rule B attachment litigation could be avoided entirely by the relatively simple option of using a different currency.[147] Yet, the Second Circuit in *Winter Storm* failed to appreciate the possibility that New York City banks might be passed-over as intermediary banks in funds transfer transmission chains. In particular,

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[142] Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 7, 8, 15; *see Consub Del.*, 543 F.3d 104; PEB, *supra* note 5, at 6 n.4.

[143] Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 8–9.

[144] *Cala Rosa*, 613 F. Supp. 2d at 431–32 n.37; Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 8.

[145] *See Consub Del.*, 543 F.3d at 109, 111; PEB, *supra* note 5, at 5 n.4; Brief for Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 11–12.

[146] PEB, *supra* note 5, at 5–6 n.4.

[147] *Id.*

Article Section 4A-302 provides a degree of flexibility to banks and originators with regard to which banks are chosen as intermediary banks.[148] Absent a contractual provision stating otherwise, a receiving bank can choose any intermediary bank through which to route an EFT.[149] Thus, if commercial parties around the world found the *Winter Storm* rule to be too costly, they could very well structure their wire transfers so as to eschew New York City banks and U.S. Dollars in order to prevent Rule B attachment from impeding their transactions.

e. Innocent Third Parties

In addition to court dockets and banking operations, the *Winter Storm* rule also threatened harm to innocent third parties and opposing parties to funds transfers. As The Federal Reserve Bank of New York explained, "[w]hen a funds transfer is attached at an intermediary bank, the funds transfer cannot be completed and the payment obligation that the originator was attempting to discharge through the use of the funds transfer remains unsatisfied."[150] It warned that this could have severe consequences not only for the party that is subject to the attachment order but also for wholly unrelated parties.[151] Indeed, the failure to complete the funds transfer and, by extension, the failure of the originator to discharge its underlying obligation under section 4A-406 could have detrimental effects on contractual relations and goodwill between commercial parties. In particular, these effects and the uncertainty that they produced certainly did not help members of the global shipping industry during the financial turmoil in the depths of the 2008-2009 global recession.[152]

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[148] *See* U.C.C. § 4A-302 (1990); U.C.C. § 4A-302 cmt. 2 (1990).

[149] *See id.* § 4A-302 cmt. 2.

[150] Brief for Amicus Curiae Federal Reserve Bank of New York, *supra* note 88, at 16–17.

[151] *See id.* at 17. The Federal Reserve Bank of New York in its amicus curiae brief further noted that the smooth functioning of the financial markets and commercial trade require parties to wholesale funds transfers to be able to "predict risk with certainty, to insure against risk, to adjust operational and security procedures, and to price funds transfer services appropriately." The brief continued explaining that "it is impossible for the parties to a funds transfer to predict and mitigate the risks associated with funds transfers that arise because of such attachment orders." *Id.*

[152] *See* Taylor, *supra* note 19, at 218 ("[T]he current economic crisis has wreaked havoc on the global shipping industry. Bulk carrier rates continue to plummet at alarming rates, (footnote omitted) global ship orders are down substantially, (footnote omitted) and huge

Regarding defendants in maritime attachment cases, one SDNY court went so far as to say that the *Winter Storm* rule was an "invitation to strategic abuse."[153] The court wrote that "because a dollar now is worth more than a dollar in the future, any litigant who can satisfy the lightweight requirement of showing a 'prima facie admiralty claim' may impose a tax on his adversary equal to the time value of money for the duration of litigation."[154] Indeed, *Winter Storm* created a series of perverse incentives for maritime plaintiffs to attach property of opposing litigants without much to preclude bad faith suits intended to temporarily disrupt a competitor's cash flow or, perhaps, to create additional leverage in transaction bargaining.

4. Untenable Uncertainty in the SDNY Regarding Rule B Jurisprudence

Possibly the most significant problem with the *Winter Storm* rule was that it created uncertainty in and undermined uniformity of Rule B jurisprudence within the SDNY.[155] It left open the question of whether funds held by an intermediary bank are property only of the originator or whether they also are property of the beneficiary, or of both parties concurrently. At question in *Winter Storm* was the validity of attaching funds held by an intermediary bank, which were *sent by a defendant-originator*. The court relied upon Rule B's broad language to find that EFTs in the hands of an intermediary bank may be attached. The opinion, however, did not offer guidance on whether maritime plaintiffs could use Rule B to attach funds held by an intermediary bank that were *en route to a defendant-beneficiary*. Consequently, SDNY courts struggled with determining how far to extend *Winter Storm's* rule beyond its facts. While some SDNY judges embraced *Winter Storm's* holding, certain other judges, fed up with what they perceive to be an abuse of the Rule B mechanism, "pushed back" by erecting barriers to the flood of Rule B claims brought in

shipping conglomerates are in the process of drastically slashing the size of their worldwide fleets.").

[153] Hannah Bros. v. OSK Mktg. and Commc'ns, Inc., 609 F. Supp. 2d 343, 351 (S.D.N.Y. 2009).

[154] *Id.* (noting that because a lawsuit's settlement value includes the costs of litigation, it would be economically irrational, all other things being equal, for a party not to attach his adversary's assets via Rule B).

[155] *See* Taylor, *supra* note 19, at 217.

the SDNY—thereby breeding uncertainty about the viability of the practice.[156]

In *HBC Hamburg Bulk Carriers GMBH & Co.*, Judge Buchwald addressed "whether, for purposes of Rule B attachment, an EFT remains the exclusive property of the sending-payor until it enters one of the banks associated with the recipient beneficiary" in a funds transfer.[157] In that case, the EFTs in question had been sent by third parties as payments to the defendants with their ultimate destination being one of the defendant's Mexican bank accounts. The attachment occurred at a New York City intermediary bank before the defendant's receipt of the funds in its Mexican bank account. Extending *Winter Storm's* holding the court found that because the defendant-beneficiary had a clear property interest in the debt owed to it by third parties and "because the EFT in the hands of the intermediary bank is intended to satisfy the debt," the defendant had a property interest in the EFT "before it was technically possessed by its own bank."[158] The defendant argued that, per *Winter Storm*, the EFTs sent by third parties remained the property of the sending-payors until the beneficiary's bank accepted the final payment order.[159] Furthermore, Judge Buchwald reasoned that funds in the hands of an intermediary are simultaneously property of both the sending-payor and the recipient-beneficiary.[160]

The following year the Second Circuit appeared to adopt Judge Buchwald's extension of *Winter Storm's* rule to make funds held by an intermediary bank attachable as property either of the originator or beneficiary. In *Aqua Stoli*, the court held that "EFTs *to or from a party* are attachable by a court as they pass through banks located in that court's jurisdiction."[161] Peculiarly, the court cited *Winter Storm* for this proposition

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[156] *Id.* at 217.

[157] *See* HBC Hamburg Bulk Carriers GmbH & Co. KG v. Proteinas y Oleicos S.A. de C.V., No. 04-civ-6884 (NRB), 2005 WL 1036127, at *3 (S.D.N.Y. May 4, 2005).

[158] *See id.* at *3–4.

[159] *Id.* at *4.

[160] *Id.* (noting that this is the logical result of the broad terms of Rule B's attachment language coupled with the overlapping property rights of sending-payors and recipient-beneficiaries in EFTs).

[161] *Aqua Stoli*, 460 F.3d at 436 (emphasis added).

despite the fact that the *Winter Storm* court never had cause to determine whether funds held by an intermediary bank are property of a beneficiary.[162] Despite clearly affirming and broadening the *Winter Storm* rule, the opinion noted that the rule had been severely criticized by various groups, including the banking entities responsible for the wire transfer system.[163] In order to confuse district courts even more, the court questioned the validity of *Winter Storm* in footnote 6 of the opinion. Judge Walker, writing for the court, stated:

> The correctness of our decision in *Winter Storm* seems open to question, especially its reliance on *Daccarett* to hold that EFTs are property of the beneficiary or sender of an EFT. Because *Daccarett* was a forfeiture case, its holding that EFTs are attachable assets does not answer the more salient question of whose assets they are while in transit. In the absence of a federal rule, we would normally look to state law, which in this case would be the New York codification of the Uniform Commercial Code, N.Y. U.C.C. Law §§ 4-A-502 to 504. Under state law, the EFT could not be attached because EFTs are property of neither the sender nor the beneficiary while present in an intermediary bank.[164]

Ironically, the *Aqua Stoli* court recognized that "post-*Winter Storm* district court cases have hardly spoken with a single voice"[165]—a problem the *Aqua Stoli* decision did not help resolve.

Seemingly in defiance of *Aqua Stoli's* explicitly broader formulation of the *Winter Storm* rule, Judge Rakoff rejected the notion that funds held by an intermediary could be the property of a beneficiary in *Seamar Shipping Corp.*, decided in late 2006.[166] He began by noting that the Second Circuit has not spoken with a unified voice on the issue. Citing Footnote 6 in *Aqua Stoli*, he explained that there was a "serious question of whether

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[162] *See id.*

[163] *Id.* at 445.

[164] *Id.* at 445 n.6 (internal citation omitted).

[165] *Id.* at 446.

[166] *See* Seamar Shipping Corp. v. Kremikovtzi Trade Ltd., 461 F. Supp. 2d 222, 224–26 (S.D.N.Y. 2006).

Winter Storm's implicit holding that EFTs may be considered to be a defendant's property," either of an originator or beneficiary, while in transit remains good law.[167] Parsing Judge Walker's language in *Aqua Stoli*, Judge Rakoff wrote that "although the attachment applied to EFTs 'to or from' the defendant, neither the court nor the parties addressed whether the funds that were actually attached had been sent to or from the defendant."[168] He noted that *Aqua Stoli's* statement that "EFTs to or from a party are attachable by a court, if construed as binding law, would substantially broaden *Winter Storm's* holding, which technically applies only where the defendant is the originator of the EFT."[169] Thus, since *Aqua Stoli* called *Winter Storm* into serious doubt, he reasoned that district courts should not broaden *Winter Storm's* rule beyond holding that funds held by an intermediary bank are property of the defendant-originator.[170] Since *Seamar Shipping* involved deciding whether funds held by an intermediary bank were property of a beneficiary, *Winter Storm* was inapplicable.[171] Without a federal precedent to bind the court, Judge Rakoff looked to New York's UCC section 4A-502 and found that the beneficiary-defendant had no property interest in the funds transfer before its bank accepts the funds.[172] Therefore, Judge Rakoff vacated the order of attachment in favor of the defendant-beneficiary.[173]

Absent a clarification from the Second Circuit after *Aqua Stoli* and *Seamar Shipping*, courts in the SDNY were faced with a choice: follow Judge Rakoff's lead and use the undertones from *Aqua Stoli's* footnote 6[174] to push back against the *Winter Storm* rule or follow the literal language of *Aqua Stoli*[175] and broadly apply Rule B. Despite the negative effects of the rule discussed *supra*, some courts in the SDNY continued to choose the

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[167] *Id.* at 224.

[168] *Id.* at 225.

[169] *Id.*

[170] *See id.*

[171] *See id.*

[172] *Id.* at 226.

[173] *See id.*

[174] *Aqua Stoli*, 460 F.3d at 445 n.6.

[175] *Id.* at 436.

latter option to permit attachment of EFTs intended for a defendant-beneficiary.[176] Notwithstanding these courts' broad applications, Judge Rakoff remained loyal to his position in *Seamar Shipping*. In early 2008, he relied on that decision to vacate another Rule B attachment order in *Shipping Corp. of India v. Jaldhi Overseas PTE Ltd.*[177] Notably, Judge Rakoff certified his decision for interlocutory appeal to the Second Circuit because of the wild divergence in SDNY applications of Rule B under *Winter Storm* and *Aqua Stoli*.[178]

Before the Second Circuit could address *Jaldhi*, however, it handed down *Consub Delaware LLC*. As in *Aqua Stoli*, the Court expressed doubt about the validity of *Winter Storm*, going as far as to note that New York City's status as a world financial center is some support for applying Article 4A to Rule B attachment cases.[179] Applying the principle of *stare decisis*, however, the court found that federal law governs the question of who owns funds in an EFT as they pass through an intermediary bank.[180] Thus, the rule of *Winter Storm* remained valid.

Some courts in the SDNY, perhaps reading *Consub Delaware* to mean that *Winter Storm* finally might be called into question in a subsequent Second Circuit opinion, began erecting barriers to successful attachment petitions by maritime plaintiffs. The court in *Cala Rosa Marine Co.*, for example, declined to recognize a mandatory continuous service standard for Rule B attachment orders.[181] Judge Scheindlin wrote that if the EFT sought to be attached is in the possession of the intermediary at the

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[176] *See, e.g.*, Mediterranea di Navigazione SPA v. Int'l Petrochemical Group S.A. 90, No. 06-civ-6700(JGK), 2007 WL 1434985 (S.D.N.Y. May 15, 2007); Dolco Inv., Ltd. v. Moonriver Dev. Ltd., 486 F. Supp. 2d 261 (S.D.N.Y. 2007); Navalmar (U.K.) Ltd. v. Welspun Gujarat Stahl Rohren, Ltd., 485 F. Supp. 2d 399 (S.D.N.Y. 2007); Compania Sudamericana de Vapores S.A. v. Sinochem Tianjin Co., No. 06-civ-13765(WHP), 2007 WL 1002265 (S.D.N.Y. Apr. 4, 2007); Gen. Tankers Pte. Ltd. v. Kundan Rice Mills Ltd., 475 F. Supp 2d 396 (S.D.N.Y. 2007).

[177] *See* Shipping Corp. of India v. Jaldhi Overseas Pte Ltd., No. 08-civ-4238(JSR), 2008 WL 2596229, at *1–2 (S.D.N.Y. June 27, 2008), *aff'd in part*, *rev'd in part*, 585 F.3d 58 (2d Cir. 2009).

[178] *See id.*

[179] *See Consub Del.*, 543 F.3d at 109, 111.

[180] *See id.* at 109.

[181] *See Cala Rosa*, 613 F. Supp. 2d at 430.

time of the attachment order, a court can but is not obligated to order continuous service.[182] She explained that the well-established prohibition against maritime attachments of after-acquired property does not obligate the bank to subsequently interrupt an EFT to satisfy the prior order, as the BNY chose to do in *Winter Storm*.[183] Finding little reason to impose such an "enormous strain" on the New York City banking system, Judge Scheindlin declined to issue an order of continuous service for the maritime plaintiff in that case.[184] This ruling severely curtailed the usefulness of Rule B attachment for maritime plaintiffs because intermediary banks ordinarily process funds transfers in less than sixty seconds.[185] Thus, under Judge Scheindlin's approach, a maritime plaintiff was not able to attach funds at an intermediary bank unless it was fortunate enough to serve the order of attachment on the bank during the few seconds in which the bank held the funds.

After deciding *Consub Delaware*, the Second Circuit itself began to retreat from a broad, plaintiff-friendly application of Rule B. In *STX Panocean*, the Court addressed various decisions by the district courts regarding what constitutes "being 'found' within the district" for the purposes of Rule B jurisdiction.[186] It held that registration as a foreign corporation authorized to do business in the State of New York would preclude a Rule B attachment against that corporation's assets.[187] This rule allowed corporations wishing to immunize themselves from the risks of Rule B attachment to register as a corporation in New York in order to preclude maritime plaintiffs from being able to demonstrate that they "cannot be found within the district," one of the elements of a Rule B prima facie case.[188] While registering as a New York corporation carries with it a number of burdens and obligations, the Second Circuit mitigated the threat of Rule B abuse, to an extent, by giving foreign corporations a choice as to

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[182] *See id.*

[183] *See id.*

[184] *See id.* at 431.

[185] Brief of Amicus Curiae The Clearing House Ass'n LLC, *supra* note 11, at 8.

[186] *See* STX Panocean (UK) Co. v. Glory Wealth Shipping Pte Ltd., 560 F.3d 127, 133 (2d Cir. 2009).

[187] *See id.* at 133.

[188] *See Aqua Stoli*, 460 F.3d at 445.

whether they would be willing to put themselves at risk of Rule B attachment.

III. *Jaldhi* and the Future of Rule B Attachment in the SDNY

By late 2009, many commentators realized that *Winter Storm* rested on questionable reasoning, created enormous burdens for New York City banks, stood at odds with Article 4A and New York law generally, and created much tension and uncertainty among courts in the SDNY.[189] *Consub Delaware* and *Aqua Stoli* indicated that the Second Circuit recognized the pitfalls of the rule and that the Second Circuit might need to engage in serious revision in the future to address the above-mentioned problems.[190] Yet, even considering the foregoing, the Court surprised the legal and commercial communities in October 2009 when it overruled *Winter Storm* in an unprecedented fashion. Part III begins with the statement of *Jaldhi* and then addresses the shortcomings of the *Jaldhi* decision.

A. The *Jaldhi* Decision

The relevant facts of the *Jaldhi* decision are as follows.[191] In March 2008, plaintiff Shipping Corp. of India entered into a charter contract with defendant Jaldhi Overseas so that Jaldhi could use Shipping Corp's vessel, the M/V Rishikesh, to transport iron ore from India to China.[192] The plaintiff transferred its vessel to the defendant and the very next day a crane on board "collapsed, killing the crane operator, halting cargo operations," causing the defendant to suspend the charter.[193] The plaintiff then sent the defendant an invoice for the charter but did not receive payment.[194] Though the charter obligated the parties to resolve disputes under English law, the plaintiff brought suit in the SDNY seeking an order of maritime attachment pursuant to Rule B on May 7, 2008 for the amount of $4,816,218.00,

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[189] *See supra* Part II.

[190] *See, e.g.*, *Consub Del.*, 543 F.3d at 109, 111; *Aqua Stoli*, 460 F.3d at 445 n. 6.

[191] For full facts of the case, see *Jaldhi*, 585 F.3d at 64–66.

[192] *Id.* at 64.

[193] *Id.* at 64–65.

[194] *Id.* at 65.

constituting the balance, interest, and attorneys' fees.[195] On May 8, 2008, the district court entered the attachment order.[196] On May 22, 2008, the defendant filed a motion to vacate the attachment in the SDNY.[197] Yet, by the time the defendant filed its motion, the plaintiff had attached almost $5 million in EFTs passing through New York City intermediary banks—a portion of which were EFTs with the defendant as the originator, but the vast majority were with the defendant as the beneficiary.[198] Then, on June 27, 2008, Judge Rakoff vacated the "May 8, 2008, attachment order insofar as it applied to EFTs of which the defendant was the beneficiary," relying on his opinion in *Seamar Shipping* for support.[199] He then certified the question for interlocutory appeal pursuant to 29 U.S.C § 1292.[200]

Judge Cabranes, writing for the Court, began the merits discussion by acknowledging that *Winter Storm* had produced a substantial body of critical commentary, including many of the arguments made in Part II of this article.[201] Like in previous cases, the Court noted that *Winter Storm* introduced uncertainty into the international funds transfer process and undermined the efficiency of New York's international funds transfer business. Judge Cabranes wrote that undermining efficiency and certainty of funds transfers in New York could, if left uncorrected, discourage dollar-denominated transactions and damage New York's standing as an international financial center.[202] This, in itself, was not a major change from previous Second Circuit decisions. Indeed, the Court had recognized in prior opinions a multitude of practical and legal criticisms of the rule but nonetheless affirmed the rule on the basis of *stare decisis*.[203] At most, the

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[195] *Id.* at 64–65 n.4.

[196] *Id.* at 65.

[197] *Id.*

[198] *See id.*

[199] *Id.* at 65–66.

[200] *Id.* at 66.

[201] *See id.* at 61–62; *supra* Part II.C.

[202] *Id.* at 62 (noting that efficiency is fostered by protecting the intermediary banks).

[203] *See Consub Del.*, 543 F.3d at 108–09; *Aqua Stoli*, 460 F.3d at 445.

Court implicitly accepted a movement to increasingly cabin *Winter Storm* by erecting various procedural barriers to Rule B attachment.[204]

Yet, unlike previous cases, Judge Cabranes explained that the Second Circuit would no longer attempt to deal with the ills of *Winter Storm* by ignoring its collateral consequences or by attempting to limit its strength by erecting further procedural barriers.[205] Instead, the Court overruled *Winter Storm* outright. Judge Cabranes wrote that:

> We overrule our previous decision in Winter Storm . . . and conclude that EFTs being processed by an intermediary banks are *not* subject to attachment under Rule B.[206]

But, why would the Court change course so dramatically? Judge Cabranes explained that there were two principal reasons for reversing a "relatively recent" case.[207] First, the Court concluded that *Winter Storm* relied upon erroneous reasoning to conclude that EFTs are attachable property.[208] Second, the Court acknowledged that the "effects of *Winter Storm* on the federal courts and international banks in New York are too significant to let this error go uncorrected simply to avoid overturning a recent precedent."[209]

While the Court cited numerous statistics to demonstrate *Winter Storm*'s detrimental impact on banks and court dockets,[210] it is clear from the court's reasoning that its first reason, the weakness of *Winter Storm*'s reasoning, was the impetus for overruling that case outright. He recounted the *Winter Storm* court's three bases of federal support in *Winter Storm*: the broad language of Rule B, the federal rule that a defendant's bank account is attachable property, and *Daccarett's* holding that an EFT while it takes

[204] *See Jaldhi*, 585 F.3d at 62–64.

[205] *See id.* at 61, 63.

[206] *Id.* at 72 (emphasis added).

[207] *See id.* at 67.

[208] *Id.*

[209] *Id.* at 67.

[210] *Id.* at 61–62.

the form of a bank credit at an intermediary bank is a seizable *res* under the forfeiture statutes.[211]

Turning first to the *Winter Storm* court's reliance on *Daccarett*, Judge Cabranes reasoned that *Daccarett* does not support a holding that the originator or beneficiary of an EFT has a *property interest* in an EFT while held by an intermediary bank because *Daccarett* did not turn on the issue of ownership of the funds; it held only that funds traceable to an illegal activity were subject to forfeiture under 21 U.S.C. § 881.[212] To be eligible for forfeiture, the EFTs needed only to be traceable to the illegal activities and, thus, the court in *Daccarett* was required only to assess whether the EFTs in that case were in fact traceable to illegal activities—no further inquiry into the issue of ownership of the EFTs was necessary.[213] By contrast, Judge Cabranes emphasized that for maritime attachments under Rule B, the question of ownership is crucial.[214]

The court then distinguished civil forfeiture actions, at issue in *Daccarett*, and maritime attachment actions, at issue in *Winter Storm* and *Jaldhi*. Read literally, Rule B has two main requirements that a plaintiff must meet to attach an EFT held by an intermediary bank: first, the EFT must be "tangible or intangible property" and second, that tangible or intangible property must be owned by the defendant.[215] Rule B requires that the defendant not be found within the district so that the *res* is the only means by which a court can obtain personal jurisdiction over the defendant. If the *res* is not the defendant's property, then the court lacks jurisdiction.[216] In contrast, civil forfeiture is a remedy *in rem*, which is based on the well-established theory that the property is itself treated as the offender and made the defendant by name or description.[217] For *in rem* remedies, such as forfeitures, ownership of the *res* is irrelevant because a court has personal jurisdiction regardless of who owns the *res* at issue. Judge Cabranes

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[211] *Jaldhi*, 585 F.3d at 67–68.

[212] *See id.* at 68–69.

[213] *Id.* at 69.

[214] *Id.*

[215] *See id.* at 66, 68–69.

[216] *Jaldhi*, 585 F.3d at 69

[217] *Id.*

concluded by stating that the distinction between remedies *quasi in rem* and *in rem* provides a principled basis for allowing EFTs to be subject to forfeiture but not attachment.[218]

Without the support of *Daccarett*, Judge Cabranes wrote that the Court is not persuaded that either the broad language of Rule B or past maritime holdings relating to defendants' bank accounts compel the Court to affirm the *Winter Storm* rule.[219] Similarly, he found no historical or functional policy rationale to compel the Court to affirm the rule.[220]

Then came the court's true innovation in its Rule B jurisprudence: it looked to state law, specifically New York's UCC Article 4A. The Court stated that since the *Winter Storm* court's three reasons were grounded exclusively in federal law, the Second Circuit did not have an occasion to look to state law to determine who, if anyone, has an ownership interest in funds in the hands of an intermediary bank.[221] Unlike previous panels in *Winter Storm*, *Aqua Stoli*, and *Consub Delaware*, the *Jaldhi* panel finally took advantage of an opportunity to substantively discuss at length how Article 4A would characterize funds held by an intermediary bank.[222]

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[218] *See id.*

[219] *Id.* at 69–70.

[220] The court opined:

> Streamlined Rule B practices, however, developed out of the concern that ships might set sail quickly, not because the courts intended to arm maritime plaintiffs with writs of attachment prior to the arrival of the ship in port. Under Winter Storm, however, maritime plaintiffs now seek writs of attachment pursuant to Rule B long before the defendant's property enters the relevant district, often based solely on the speculative hope or expectation that the defendant will engage in a dollar-denominated transaction that involves an EFT during the period the attachment order is in effect. Such practices, which have increased dramatically since Winter Storm, bear little, if any, relation to the text of Rule B or to our jurisprudence relating to the bank accounts of maritime defendants.

Id. at 70.

[221] *See id.* at 68.

[222] *See id.* at 70–71 (noting that in the absence of applicable federal law, the court generally looks to state law for guidance on the question).

In a clear and concise explication of Article 4A, the court firmly stated that New York law does not permit the attachment of EFTs in the possession of an intermediary bank.[223] Citing section 4A-503, the court noted that Article 4A allows a court to restrain the beneficiary's bank from releasing funds to the beneficiary or the beneficiary from withdrawing funds.[224] Article 4A also permits a court to attach an originator's funds before the originator's bank executes an originator's payment order.[225] Section 4A-503, however, explicitly states that a court may not otherwise restrain *any* activity with respect to a funds transfer.[226] The court looked to the authoritative comment to section 4A-502, which states that "until the funds transfer is completed by acceptance by the beneficiary's bank of a payment order for the benefit of a beneficiary, the beneficiary has no property interest in the funds transfer which the beneficiary's creditor can reach"[227] to find that, under New York law, EFTs are neither property of the originator nor the beneficiary of a funds transfer while they are briefly in the possession of an intermediary bank.[228] The logical extension of this characterization of New York law, according to the court, is that EFTs cannot be subject to attachment under Rule B since the EFTs would not permit a plaintiff to satisfy one of the key elements of his prima facie case: that the EFTs are property of the defendant-originator or the defendant-beneficiary.

B. Open Questions from *Jaldhi*

While the Second Circuit finally reached the correct result with regard to EFTs passing through intermediary banks in *Jaldhi*, it may have failed to permanently lay to rest the dangers inherent in *Winter Storm*'s reasoning. Perhaps New York City banks and SDNY dockets are not yet out of danger.

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[223] *See id.* at 70.

[224] *Id.* at 70–71; *see* U.C.C. § 4A-503 (1990); U.C.C. § 4A-503 cmt. (1990).

[225] *See Jaldhi*, 585 F.3d at 70; *see also* U.C.C. § 4A-503 (1990); U.C.C. § 4A-503 cmt. (1990).

[226] *See Jaldhi*, 585 F.3d at 70–71; *see also* U.C.C. § 4A-503 (1990) (emphasis added); U.C.C. § 4A-503 cmt. (1990).

[227] *See Jaldhi*, 585 F.3d at 71 (quoting U.C.C. § 4A-502 cmt. 4 (1990)).

[228] *See id.*

1. Time Scope of *Jaldhi* Rule

First, the *Jaldhi* court did not specify whether its decision should be applied by courts in the SDNY retroactively or only prospectively. Even though it was clear that SDNY courts would no longer be permitted to order attachment of EFT funds held by an intermediary bank against the interests of a defendant-beneficiary or defendant-originator, there was a significant number of pending motions for attachment and motions for vacatur with regard to previously granted orders of attachment in the SDNY at the time *Jaldhi* was handed down.[229] Would the Second Circuit permit these orders to stand?

This question promptly was answered in the negative in *Hawknet Ltd. v. Overseas Shipping Agencies*. The Second Circuit stated that the presumption against retroactive application of statutes and regulations does not apply with respect to *Jaldhi* rule.[230] It reasoned that when a court "applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law [in the case of *Jaldhi*, interpretation of Rule B] and must be given full retroactive effect in all cases still open on direct review."[231] Thus, it held that because it applied the rule it announced in *Jaldhi* to the parties in that case, the *Jaldhi* rule applies retroactively to all cases open on direct review, including *Hawknet*.[232]

2. Dangerous Dicta: EFTs as Temporary Property of Intermediary Banks

Next, the Court left open the possibility that EFTs in the hands of an intermediary bank remain, despite *Jaldhi's* holding, attachable by a creditor in some situations. While the court issued a powerful and persuasive decision, its opinion included some dicta that might imply that funds held by intermediary banks still could be subject to capture. In particular, footnote 13 leaves open the question of whether property rights regarding EFTs, or their constituent payment orders, must vest in some entity at all times.[233] The court considered whether "New York law envisages EFTs as

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[229] *See* PEB, *supra* note 5, at 5 n.4.

[230] *See* Hawknet Ltd. v. Overseas Shipping Agencies, 590 F.3d 87, 91 (2d Cir. 2009).

[231] *Id.* (quoting Harper v. Virginia Dep't of Taxation, 509 U.S. 86, 97 (1993)).

[232] *See id.*

[233] *See Jaldhi*, 585 F.3d at 71 n.13.

the property of the intermediary bank for the short while or instant during which they remain in the bank's possession."[234] Because this question was not presented in *Jaldhi*, however, the court stated that it would not address it further. Nonetheless, the court in further dicta attempted to allay any fear of another Rule B catastrophe for banks and courts under this hypothetical scenario. Judge Cabranes wrote,

> If, however, a court were to find that the EFTs were property of the intermediary bank, it would have no effect on the application of Rule B. If EFTs are the property of the intermediary bank and that bank is a defendant for purposes of Rule B, then the property would still not be subject to Rule B attachment because these intermediary banks are necessarily "found within the district" in which the EFTs are found and Rule B only allows the attachment of property within the district that belongs to defendants "not found within the district."[235]

It is true that a rule that funds held by a NYC intermediary bank are the "property" of the intermediary bank would have "no effect" on the application of Rule B. Judge Cabranes correctly noted that such intermediary banks would be free from Rule B process because they would be "found within the district" such that Rule B would be inapplicable to them.[236] But, these dicta and the notion that a bank might "own" the funds it holds momentarily as an intermediary bank in a funds transfer are incorrect as a matter of New York law and policy.

a. Footnote 13 is Incorrect as a Matter of New York Law

As a matter of law, footnote 13 contradicts the insulated nature of a wire transfer as conceived of by New York's Article 4A. The drafters of Article 4A took great care in creating a fast, low-cost, and efficient payment system where payment, once initiated by an originator, is virtually irrevocable.[237] Businesses depend on the system's reliability—which is fostered by keeping a funds transfer significantly insulated from outside

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[234] *See id.*

[235] *Id.*

[236] *See id.*

[237] *Banque Worms*, 570 N.E.2d at 194–95; *See* Mann, *supra* note 1, at 225.

process.[238] In order to create this insulation, the drafters intended that a funds transfer would be understood by courts as nothing more than a series of independent contractual obligations between banks to carry out the instructions of an originator. The drafters of Article 4A specified that "[a]lthough 4A follows convention in using the term 'funds transfer'" to identify a payment from the originator to the beneficiary, "no money or property right" of the originator is actually transferred to the beneficiary.[239] The logical extension of this statement is that no money or property right of the originator passes through an intermediary bank on its way to the beneficiary.

To hold that an intermediary bank might have a property or ownership interest in a mere contractual obligation that it has with a preceding or subsequent bank in a funds transfer would ignore the intentions of the UCC drafters that banks should not have vested property rights in EFT payment orders they hold as intermediary banks. For example, Article 4A's "money back guarantee" is evidence that the drafters did not intend an intermediary bank to have an ownership interest in funds it momentarily holds during a funds transfer. The guarantee, found in section 4A-402(c), states that "[t]he obligation of [the] sender to pay its payment order is excused if the funds transfer is not completed by acceptance by the beneficiary's bank of a payment order instructing payment to the beneficiary of that sender's payment order."[240] If an intermediary bank had a vested ownership interest in the funds it handles during a funds transfer, property law might recognize such bank's independent right to pull the money out of the wire transfer system. However, if an intermediary bank were to pull funds out of the chain of transmission unilaterally such that the beneficiary's bank never accepts the funds, section 4A-402(c) would compel the intermediary bank to reimburse the bank from which it received the payment order in the amount of the payment order.[241] In other words, an intermediary bank cannot pull funds out of the wire transfer system without having to pay back the money to the sender of the payment order. If an intermediary bank cannot pull funds out of the system without suffering any

[238] *See, e.g.*, U.C.C. § 4A-502 (1990); U.C.C. § 4A-502 cmt. 1-5 (1990); U.C.C. § 4A-503 (1990); U.C.C. § 4A-503 cmt. (1990).

[239] U.C.C. § 4A Prefatory Note, ¶ Concept of acceptance and effect of acceptance by the beneficiary's bank. (1990).

[240] U.C.C. § 4A-402(c) (1990); U.C.C. § 4A-402 cmt. 2 (1990).

[241] *See* U.C.C. 4A-402(c) (1990); U.C.C. § 4A-402 cmt. 2 (1990).

repercussions under Article 4A, the drafters probably did not intend banks to have any vested property right with regard to funds they hold as intermediary banks in a funds transfer. The Second Circuit ignored the above-discussed nature of funds transfers under New York law previously in *Winter Storm* and the results were disastrous for banks and courts.[242] The court should apply a strong and continuing presumption against departing from the Article 4A drafters' careful construction of the wire transfer system.

b. Footnote 13 is Unsound as a Matter of Policy

As a matter of sound policy, footnote 13 represents a potential source of precedent to re-introduce *Winter Storm*-esque notions of property rights into the wire transfer chain of transmission. Judge Cabranes correctly explained that Rule B would not be affected by a ruling that an intermediary bank has a vested property interest in the funds it holds during a funds transfer.[243] However, this reasoning does not guarantee in perpetuity that plaintiffs would be precluded from relying upon other, or not-yet-enacted, federal jurisdictional statutes to attach "property owned by intermediary banks." That this is a speculative danger is conceded by the author. But, how many commentators in 1993—when *Daccarett* was decided—anticipated that *Daccarett* would be used as the chief support for allowing attachment of funds held by an intermediary bank under Rule B?[244] How many of those commentators foresaw the damage to banks and court dockets caused by *Winter Storm*?[245] To protect the future of the wire transfer system, the court should refrain from making broad statements about ownership interests in funds transfers, even in speculative dicta, which are at odds with rights, obligations, and characterizations under Article 4A.

3. Questionable Procedural Technique to Overrule *Winter Storm*

Finally, the *Jaldhi* court potentially left *Jaldhi* open to attack because the court relied on the "mini *en banc*" procedure to overrule *Winter Storm* as precedent. The *Jaldhi* panel acknowledged "that a panel of [the

[242] *See supra* Part II.

[243] *See Jaldhi*, 585 F.3d at 71 n.13.

[244] *See Winter Storm*, 310 F.3d at 278.

[245] *See supra* Part II.

Second Circuit] is 'bound by the decisions of prior panels until such time as they are overruled either by an *en banc* panel of [the Second Circuit] or by the Supreme Court.'"[246] However, Judge Cabranes, citing *United States v. Crosby* and *Jacobson v. Fireman's Ins. Co.*, wrote that because the opinion was circulated to all active members of the Court prior to filing and no judge objected, the *Jaldhi* panel could overrule its binding precedent in *Winter Storm*.[247] Thus, the *Jaldhi* panel was willing to use this unconventional procedure to break with *stare decisis*, despite not sitting *en banc* and despite there being no opinion overruling binding precedent by the Supreme Court.[248]

It is questionable, however, whether the court had the authority to break *stare decisis* in this manner. One commentator wrote that closer scrutiny of the two cases upon which the court relied for procedural precedent reveals that each case used the mini *en banc* approach "to overrule a prior panel only because of intervening circumstances."[249] A close reading of *Crosby* reveals that the Second Circuit was not writing in

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[246] *Jaldhi*, 585 F.3d at 67 & n.9 (citing United States v. Wilkerson, 361 F.3d 717, 732 (2d Cir. 2004)).

[247] *See id.* at 67 (citing United States v. Crosby, 397 F.3d 103, 105 n.1 (2d Cir. 2005); Jacobson v. Fireman's Ins. Co., 111 F.3d 261, 268 n.9 (2d Cir. 1997)). In *Crosby*, the defendant appealed his firearms conviction after he received a ten year sentence as a result of a mandatory application of the Federal Sentencing Guidelines by his sentencing judge in which he received several enhancements based on facts found by the sentencing judge but not the sentencing jury. *See Crosby*, 397 F.3d at 106. The Second Circuit faced the issue of whether to remand the case to allow the district court to resentence the defendant in light of the Supreme Court's intervening case, *Booker*, which made the Federal Sentencing Guidelines advisory as opposed to mandatory. *See id.* at 105–06. The Court held that the sentencing judge committed a Sixth Amendment violation "by mandatorily selecting a sentence dictated by the applicable Guidelines range, which had been calculated on the basis of facts not found by a jury or admitted by the Defendant." *Id.* at 119–20. In *Jacobson*, the plaintiff insured appealed the dismissal of his complaint against the defendant insurer for the defendant's denial of payment of claims under the plaintiff's policy arising from damage to the plaintiff's insured residence. *See Jacobson*, 111 F.3d at 262. The Second Circuit held that the plaintiff's first action in state court, even though it was an unconfirmed umpire's decision in a mandatory appraisal process for disputed insurance claims, barred his subsequent action in federal court on the basis of res judicata. *See id.*

[248] *See Jaldhi*, 585 F.3d at 67 n.9 (citing United States v. Wilkerson, 361 F.3d 717, 732 (2d Cir. 2004)); United States v. Parkes, 497 F.3d 220, 230 n.7 (2d Cir. 2007) (discussing the "mini *en banc*" procedure).

[249] Taylor, *supra* note 19, at 215.

the absence of a binding Supreme Court decision. Judge Newman wrote that the "appeal of a sentence imposed in a federal criminal case requires us to begin the process of implementing the decision of the Supreme Court in *United States v. Booker*."[250] Although the Second Circuit was acting pursuant to a Supreme Court ruling, it nevertheless circulated the opinion to all judges on the court.[251] Judge Newman explained that circulation of the opinion served a functional, rather than procedural purpose. He wrote:

> In considering this issue, we are mindful that this will be the first sentencing appeal decided by our Court since the decision in *Booker/Fanfan*. As such, it will likely be of special interest to the district judges of this Circuit as they confront a host of new issues. . . . In formulating our thoughts on these matters, the members of this panel have greatly benefitted [sic] from numerous suggestions and comments *by other judges of this Court*.[252]

Consequently, it appears that the *Crosby* panel did not rely on the mini *en banc* procedure as a means to legitimize a decision overruling binding Second Circuit precedent in the absence of an *en banc* decision or a relevant Supreme Court order. Instead, the court apprised all Second Circuit judges of its decision because of the momentous impact of implementing the Supreme Court's landmark decision in *Booker*, which fundamentally altered the way in which district judges sentence convicted criminals.[253] By contrast the *Jaldhi* court's reliance on a mini-*en banc* procedure was not backed by any relevant Supreme Court ruling.[254]

Furthermore, the intervening circumstance similar to that in *Jacobson* is also absent in *Jaldhi*. On the one hand, *Jacobson* on its face appears to provide some support for the *Jaldhi* court's use of mini *en banc* as the procedural underpin to overruling binding precedent. Footnote 9 explained that the opinion—overturning a prior Second Circuit decision—

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[250] *See Crosby*, 397 F.3d at 105 (citing United States v. Booker, 543 U.S. 220, 160 (2005)).

[251] *See id.* at 105 n.1.

[252] *Id.* at 106–07 (emphasis added).

[253] *See id.* at 105 n.1, 106–07.

[254] *See Jaldhi*, 585 F.3d at 67 & n.9.

was circulated to all active members and none had objected to its filing.[255] However, a close reading of the case reveals that the court overruled its own precedent in *Leddy*,[256] in part, because of an intervening ruling from the New York Court of Appeals. Judge Jacobs wrote that

> [o]ur holding contradicts certain statements in *Leddy*; but this Court has an ongoing duty to predict how the Court of Appeals would decide an issue based on the best information currently available, and in this case we now have the benefit of important additional data. Our conclusion that an unconfirmed umpire's determination may (in certain circumstances) have *res judicata* effect rests on *Protocom*[257] and the later decisions following *Hilowitz*,[258] authority that was not available when the *Leddy* Court ruled.[259]

Since *Jaldhi* did not overrule *Winter Storm*, in part, because of intervening pronouncements on New York law from the New York Court of Appeals, it is unclear whether *Jacobson* provides a sound basis for the *Jaldhi* panel's use of circulation in lieu of an *en banc* ruling. Thus, arguably neither *Crosby* nor *Jacobson* provide support for the *Jaldhi* court's use of mini-*en banc* as the procedural underpin to overruling binding precedent.

So far, at least one plaintiff has made an argument to an SDNY court that *Jaldhi* did not properly overrule *Winter Storm* because it was not an *en banc* decision.[260] Only time will decide the propriety of the Second Circuit's procedural strategy.

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[255] *Jacobson*, 111 F.3d at 268 n.9.

[256] Leddy v. Standard Drywall, Inc., 875 F.2d 383 (2d Cir. 1989).

[257] Protocom Devices, Inc. v. Figueroa, 173 A.D.2d 177 N.Y.S.2d 80 (1991).

[258] Hilowitz v. Hilowitz, 85 A.D.2d 621, 444 N.Y.S.2d 948 (1981).

[259] *Id.* at 268.

[260] *See* World Fuel Serv. Sing. PDE Ltd. v. PT Smoe Indon., No. 09-civ-6300(JGK), 2009 WL 4016620, at *1 (S.D.N.Y. Nov. 16, 2009) (Koeltl, J.).

Conclusion

With *Jaldhi*, it seems that the Second Circuit has put an end to the Rule B maritime attachment madness that had gripped New York City banks and the SDNY since the court decided *Winter Storm*. As of the writing of this article, the law of the Second Circuit holds that EFTs are not attachable property of either the originator nor a beneficiary of a wire transfer. It is vital for wise judicial administration in the SDNY, the continuing efficiency and low costs associated with the wire transfer system, and the importance of New York City as a center of world finance for the court to adhere to its holding in *Jaldhi* and refrain form departing from the careful balancing of interests attained in the drafting of UCC Article 4A. The court should address the shortcomings of *Jaldhi* opinion to foreclose the possibility that damage caused by *Winter Storm* reoccurs in the future.

Sacrificing the Utility of Counter-Guarantees and Counter Standby Letters of Credit for International Infrastructure Projects by Neglecting the Virtues of Strict Adherence to the Independence Principle: *American Express Bank Ltd. v. Banco Espanol de Credito*

Andrey V. Kuznetsov*

Introduction

From harbors to hospitals, major infrastructure projects in developing countries transform local landscapes with a promise to provide vital services to millions of people all over the globe while offering investors access to highly lucrative construction markets in those parts of the world. But large-scale infrastructure projects involve a complex nexus of a multitude of contracts among various entities from different countries.[1] The need for long-term coordination of action among the multitude of actors from all over the world involved in such construction projects adds to their considerable riskiness.[2] One key factor facilitating the completion of these projects is the ability of the project owners to hedge against the significant risk of non-performance by obtaining independent guarantees or standby letters of credit ("standbys") from financial institutions located in the host country where the project is being built.[3] These two undertakings

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[1] *See* David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT'L L. REV. 51, 52 (2005).

[2] *Id.*; *see* ROELAND BERTRAMS, BANK GUARANTEE IN INTERNATIONAL TRADE: THE LAW AND PRACTICE OF INDEPENDENT (FIRST DEMAND) GUARANTEES AND STANDBY LETTERS OF CREDIT IN CIVIL LAW AND COMMON LAW JURISDICTIONS 2 (3d ed. 2004).

[3] *See, e.g.*, Foxboro Co. v. Arabian American Oil Co., 805 F.2d 34, 36 (1st Cir. 1986); *see also* JAMES E. BYRNE, HAWKLAND UNIFORM COMMERCIAL CODE SERIES, VOLUME 6B, [REV.] ARTICLE 5 LETTERS OF CREDIT, § 5-102:55 (West Group Pub. 2010) [hereinafter HAWKLAND]; BERTRAMS, *supra* note 2, at 2–3; Barru, *supra* note 1, at 51, 95–96. An independent guarantee or a standby can be formally defined as an irrevocable, definite undertaking by issuer of a standby or independent guarantee to pay upon the presentation by the beneficiary of the documents required by the terms of the standby or independent guarantee, such as a certificate of default, that the beneficiary prepares for its own benefit, alleging that the person who applied for issuance of a standby or independent guarantee defaulted on or failed to perform the underlying contract. HAWKLAND, §§ 5-105:125, 5-

have emerged at the same time, serve similar function, namely the furnishing of security to assure performance, and are equivalent at the abstract level of law.[4] Both types of undertakings belong to the letter of credit family of independent undertakings which also includes commercial letters of credit.[5]

Independent guarantees and standbys safeguard against the risk of non-performance because they, being governed by the independence (autonomy) principle, are available even when there are disputes about performance or propriety of payment.[6] According to this principle, the independent guarantee or standby issuer's obligation to pay the beneficiary upon proper demand under the undertaking is not affected by events arising out of the underlying contract.[7] The result is that the independence principle

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105:126; International Chamber of Commerce, *The International Standby Practices (ISP98)*, Rule 1.06, ICC Publication No. 590 (Jan. 1, 1999) [hereinafter ISP98]; *American Express*, 597 F. Supp. 2d at 401–02; Hendry D. Gabriel, *Standby Letters of Credit: Does the Risk Outweigh the Benefits?,* 1988 COLUM. BUS. L. REV. 705, 709 (1988). Importantly, the two types of undertakings do not represent a demand for immediate payment for a transaction in goods or services. HAWKLAND §§ 5-105:125, 5-105:126.

[4] HAWKLAND, *supra* note 3, § 5-101:6; BERTRAMS, *supra* note 2, at 7. Unlike standbys, however, which evolved from the commercial letter of credit, a quintessentially independent undertaking, the matrix for "independent" guarantees was a suretyship or accessory guarantee, an inherently dependent undertaking. HAWKLAND, *supra* note 3, § 5-102:134. Note that there are multitude of names that refer to these types of independent undertakings including bank guarantees, independent bank guarantees, demand guarantees, international demand guarantees, simple demand guarantees and performance guarantees. Barru, *supra* note 1, at 66. A dependent undertaking, such as accessory guarantee or suretyship, means that the accessory guarantor can invoke defenses derived from the contract except to the extent excluded. *See* BERTRAMS, *supra* note 2, at 2. Independent undertakings by contrast are abstracted from the underlying contract as a class. *See* HAWKLAND, *supra* note 3, § 5-102:131.

[5] HAWKLAND, *supra* note 3, § 5-103:2.

[6] Sztejn v. J. Henry Shroder Banking Corp., 31 N.Y.S.2d 631, 634–35 (N.Y. Sup. Ct. 1941); BERTRAMS, *supra* note 2, at 2–3, 12; *see* Roman Ceramics Corp. v. Peoples Nat'l Bank, 714 F.2d 1207, 1213 (3d Cir. 1983) (quoting Intraworld Indus. Inc. v. Girard Trust Bank, 336 A.2d 316, 323–24 (Pa. 1975)); Barru, *supra* note 1, at 89 ("The independence principle is intended to promote the commercial vitality of letters of credit and bank guarantees by ensuring the beneficiary quick easy payment so long as conforming documents are presented to the issuing bank. The bank's role is limited to the ministerial function of reviewing the documents for conformance with the terms of credit.").

[7] BERTRAMS, *supra* note 2, at 11; Ross P. Buckley and Gao Xiang, *The Unique Jurisprudence of Letters of Credit: Its Origin and Sources*, 4 SAN DIEGO INT'L L.J. 91, 118–19 (2003); *see* International Chamber of Commerce, *ICC Uniform Rules for Demand*

assures the beneficiary of an independent guarantee or standby the benefit of money in hand before any litigation over the underlying contract occurs.[8] In letters of credit, the independent character of the undertaking is linked to its documentary nature.[9] The very core of the concept of independence is reliance on representations embodied in documents without seeking to determine ultimate facts. Rev. UCC Article 5,[10] and private sets of rules for independent undertakings promulgated under the auspices of the International Chamber of Commerce ("ICC"), UCP600[11], ISP98[12], and URDG 758[13], all expressly incorporate the independence principle.

Guarantees (URDG 758), Art. 5, ICC Publication No. 758 (July 1, 2010) [hereinafter URDG 758]; International Chamber of Commerce, *The Uniform Customs and Practice for Documentary Credits (UCP600)*, Art. 4, ICC Publication No. 600 (July 1, 2007) [hereinafter UCP600]; ISP98, *supra* note 3, Rule 1.06, 1.07; Rev. U.C.C. § 5-103(d) (1995).

[8] Southern Energy Homes, Inc. v. AmSouth Bank of Alabama, 709 So. 2d 1180, 1185−87 (Ala. 1998) (citing JOHN DOLAN, THE LAW OF LETTER OF CREDIT: COMMERCIAL AND STANDBY CREDITS (REV. ED. 1996)); *see* Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218, 241 (1985) (the important purpose of the letter of credit is to shift "the risk of litigation and avoid expensive premature procedures that test the propriety of a demand."). The ability of beneficiary to obtain funds before commencement of dispute with the applicant encourages hesitant beneficiaries to enter into international contracts by allowing the beneficiaries to shift onto the applicant the risk of having to bring a claim and the risk that the beneficiary will demand payment under the independent guarantee or standby without justification. *Southern Energy Homes*, 709 So. 2d at 1186−87 (quoting AmSouth Bank, N.A. v. Martin, 559 So. 2d 1058, 1062 (Ala. 1990)). At the same time, by making applicants bear some of the risk of default, independent guarantees and standbys provide applicants with forceful incentive to fully perform. *See* BERTRAMS, *supra* note 2, at 14; Barru, *supra* note 1, at 61−63.

[9] HAWKLAND, *supra* note 3, § 5-103:2.

[10] Rev. U.C.C. § 5-103(d) (1995) (Scope) ("Rights and obligations of an issuer to a beneficiary . . . under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.").

[11] UCP600, *supra* note 7, Art. 4 ("A beneficiary can in no case avail itself of the contractual relationships existing between banks or between the applicant and the issuing bank.").

[12] ISP98, *supra* note 3, Rule 1.06, 1.07 (affirming the independent, documentary, and binding character of ISP standbys).

[13] URDG 758, *supra* note 7, Art. 5(a) ("A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned or bound by such relationship.").

The independence principle is not absolute. The most important exception to the principle is the doctrine of fraud in the transaction.[14] The fraud rule establishes circumstances under which the bank might be required to take into account performance of the underlying contract and under which courts may enjoin payments under a letter of credit.[15]

The independence principle is also the cornerstone of independent undertakings in the form of counter-guarantees and counter-standbys which play a particularly important role in facilitating large-scale infrastructure projects in the developing world.[16] Specifically, a counter-guarantee/counter-standby is a cash-like promise that in turn enables the issuance of independent guarantee/standbys to local beneficiaries from banks located within the beneficiary government's territorial jurisdiction.[17] A counter-guarantee or counter-standby arrangement adds an additional layer of obligations to the typical three separate obligations between applicant and beneficiary, applicant and issuing bank, and issuing bank and beneficiary characteristic of independent guarantees and standby letters of

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[14] Barru, *supra* note 1, at 82−83. *See infra* Part II.B.1

[15] Jacqueline D. Lipton, *Documentary Credit Law and Practice in the Global Information Age*, 22 FORDHAM INT'L L.J. 1972, 1979 (1999). Courts have recognized that proliferation of letter of credit fraud threatens their utility no less than the erosion of the independence principle. *See* Itek Corp. v. First Nat. Bank of Boston, 511 F. Supp. 1341, 1351 (D. Mass 1981) ("[T]he failure to issue an injunction where otherwise appropriate would send a clear signal to those inclined to engage in fraudulent activities that they are likely to be rewarded. Such a result would have an even greater adverse impact upon issuing banks and ultimately discourage the use of letter of credit."), *aff'd*, 730 F.2d 19 (1st Cir. 1984); Dynamics Corp. of America v. Citizens and Southern Nat. Bank, 356 F. Supp. 991, 1000 (N.D. Ga. 1973) ("[T]here is as much public interest in discouraging fraud as in encouraging the use of letters of credit."). On the other hand, because the fraud rule strikes at the heart of the independence principle, an overly expansive fraud rule also threatens the commercial viability of letters of credit. *See* Ross P. Buckley and Gao Xiang, *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, 13 DUKE J. COMP. & INT'L L. 293, 333−34 (2003).

[16] BERTRAMS, *supra* note 2, at 18−19, 196.

[17] *See* HAWKLAND, *supra* note 3, §§ 5-101:6, 5-102:55; Barru, *supra* note 1, n.248 (quoting BROOKE WUNNICKE ET AL., STANDBY AND COMMERCIAL LETTERS OF CREDIT 2.08, at 2-56 (3d ed. 2000 & 2004 Supp.) ("In some countries and for some projects, a bank guarantee is required to be issued by a bank in the host country. The bank may refuse to do so without a supporting guarantee from another bank. The latter guarantee is known as a counter-guarantee and could take the form of a standby letter of credit issued by a U.S. bank.").

credit.[18] Under a counter-guarantee/counter-standby arrangement the local bank becomes the beneficiary of the counter-guarantee/counter-standby ("local bank") and applicant's bank issues and undertakes to honor the counter-guarantee/counter-standby upon a complying presentation ("counter-guarantor", "issuer of counter-standby").[19] This arrangement became prevalent in international project finance because beneficiaries located in developing countries are often leery of working with unfamiliar foreign institutions and prefer to deal with a bank located within the beneficiary country's jurisdiction.[20] Banks located in the beneficiary's country are willing to issue a separate undertaking in favor of the beneficiary, a Middle Eastern company for example, if the applicant's bank assures the local bank's separate undertaking by issuing a counter-guarantee/counter-standby naming the local bank as beneficiary.[21] The counter-guarantor/issuer of counter-standby agrees to reimburse the local bank upon complying with the terms of the counter-guarantee/counter-standby.[22] Importantly, although the local undertaking need not be independent, the undertaking of the local bank that is the beneficiary of the counter-guarantee/counter-standby is independent from that of the counter-guarantor/issuer of the counter-standby.[23] ISP98 and URDG 758, the ICC-

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[18] Ensco Envtl. Serv. V. United States, 650 F. Supp 583, 588 (W.D. Mo. 1986); Buckley & Xiang, *supra* note 7, at 98. The three obligations consist of (i) the underlying contract between the beneficiary and the applicant/principal; (ii) the contract between the applicant/principal and the bank issuing the independent guarantee or standby in favor of the beneficiary, describing the terms the issuer must incorporate into the credit and establishing the reimbursement agreement between applicant/principal and issuer; and (iii) the issuing bank's obligation to pay the beneficiary of the independent guarantee or standby upon proper demand. HAWKLAND, *supra* note 3, § 5-102:126; BERTRAMS, *supra* note 2, at 18–20; Lipton, *supra* note 15, at 1973.

[19] *See* HAWKLAND, *supra* note 3, § 5-102:126.

[20] American Express Bank, Ltd. v. Banco Espanol de Credito, 597 F. Supp 2d. 394, 398 (S.D.N.Y. 2009) (citing JOHN DOLAN, THE LAW OF LETTER OF CREDIT: COMMERCIAL AND STANDBY CREDITS 1-16 (REV. ED. 1996)); HAWKLAND, *supra* note 3, § 5-102:55 ("This practice emerged as a result of the experience of Middle Eastern companies and governments with excessive issuance of injunctions and similar orders issued by Western courts, including those in the US. It has effectively immunized Middle Eastern counter parties by enabling them to draw on undertakings issued subject to their own law issued by banks subject to their jurisdiction.").

[21] HAWKLAND, *supra* note 3, § 5-102:55.

[22] BERTRAMS, *supra* note 2, at 196.

[23] HAWKLAND, *supra* note 3, §§ 5-102:55, 5-102:126.

endorsed rules designed to govern independent guarantees and standbys, respectively, expressly recognize the independence of the counter-standby or counter-guarantee from any local undertaking issued by the beneficiary of the counter-guarantee or counter-standby.[24]

However, the commercial utility of counter-guarantees/counter-standbys is not invulnerable. Contrary to the limitations imposed by the independence principle, applicants and issuers of independent undertakings do attempt to invoke the status of the underlying contract to prevent honor of the undertakings when disputes over that contract erupt.[25] Given that the independence principle is the source of commercial vitality of counter-guarantees/counter-standbys, judicial circumvention of the independence principle warrants caution because any such action potentially risks eroding the commercial utility of these types of undertakings.[26]

In *American Express Bank Ltd. v. Banco Espanol de Credito*[27] the United States District Court for the Southern District of New York ("district court") confronted such a situation where the dispute in the underlying international construction contract between an applicant and a beneficiary from different countries lead to cancellation of the beneficiary's

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[24] URDG 758, *supra* note 7, Art. 5(b) ("A counter-guarantee is by its nature independent of the guarantee, the underlying relationship, the application and any other counter-guarantee to which it relates, and the counter-guarantor is in no way concerned with or bound by such relationship."); ISP98, *supra* note 3, Rule 4.21; JAMES E. BYRNE, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES 197 (1998) (A "counter-standby" may recite or even contain in an exhibit the terms of the separate undertaking, and the request that the stanby beneficiary (Bank X) issue the undertaking. [Rule 4.21] affirms the understanding of the standby community that these two undertakings are separate and independent from one another, and the standby issuer has no relationship with the beneficiary (Bank X) other than that evidenced by the standby itself."). Although Rev. U.C.C. Article 5 does not expressly address counter-guarantees or counter-standbys, it incorporates inferentially the independence of local undertaking from the counter-guarantee/standby by virtue of encompassing independent guarantees and standbys. *See* HAWKLAND, *supra* note 3, § 5-102:55.

[25] *See* Buckley & Xiang, *supra* note 15, at 308−09 ("In the commercial world, there are almost limitless ways in which an applicant's bargain with a beneficiary may go sour. When this happens, the applicant will be tempted to use every means to escape from its original bargain.").

[26] *See Roman Ceramics*, 714 F.2d at 1213; *Southern Energy Homes*, 709 So. 2d at 1185−86; Barru, *supra* note 1, at 88−89.

[27] 597 F. Supp 2d. 394 (S.D.N.Y. 2009).

independent guarantees and to an injunction to prevent the honoring of local bank's counter-guarantee.[28] The district court incorrectly held that the local bank does not have a right to immediate payment under its counter-guarantees regardless of whether the local bank has paid the beneficiary under its independent guarantees and despite its refusal to do so.[29] The court reasoned that in light of the ICC arbitral award in favor of the applicant, under Rev. UCC § 5-109 (Forgery and Fraud) the beneficiary lacked "any basis in law or fact" to demand payment under the independent guarantees.[30] Accordingly, the district court reasoned that the local bank had no obligation to pay the beneficiary under the beneficiary's independent guarantees. Therefore, the district court concluded that until a court of law vacates or modifies the arbitral award, neither the beneficiary nor the local bank has a "colorable right" to demand honor of the independent guarantees and counter-guarantees, respectively.[31]

The district court's ruling unduly circumscribed the independence principle by making the ability of local banks to obtain payment under their counter-guarantees/counter-standbys be noticeably sensitive to the status of the underlying construction contract. To demonstrate this, Part I will present the Statement of the Case. Part II, the analysis section, will then show that relying on decisions of arbitral panels concerning the underlying contract as basis for not enforcing payment obligations under independent guarantees/standbys and counter-guarantees/counter-standbys is not well grounded in contract law, international law, standard international letter of credit practice and New York law. Part II will show that contrary to the independent nature of the relationship between the local undertaking and the counter-guarantee/counter-standby, the district court effectively treated the two undertakings as dependent, thereby conflating them. This part will

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[28] *Id.* at 402. Legal decisions coming out of New York State on letters of credit issues have significant impact on that area of jurisprudence and practice. New York is a major world commercial and financial center having highly developed commercial law and as such generates a considerable amount of letter of credit case law. Banco Nacional De Mexico, S.A. v. Societe Generale, 820 N.Y.S.2d 588, 592 (N.Y. App. Div. 2006) ("As a primary financial center and a clearinghouse of international transaction, the state of New York has a strong interest in maintaining its preeminent financial position and in protecting the justifiable expectation of the parties who choose New York law as the governing law of a letter of credit."). *See* SCOTT L. HOFFMAN, THE LAW AND BUSINESS OF INTERNATIONAL PROJECT FINANCE, 409 (3d ed. 2008).

[29] *American Express*, 597 F. Supp. 2d at 400, 403–05.

[30] *Id.* at 403.

[31] *Id.*

also demonstrate that the district court failed to properly observe the case law-developed standard for issuing injunctions when the court effectively upheld (i) the Spanish court's injunction to prevent the counter-guarantor from honoring the local bank's counter-guarantee; and (ii) the ICC arbitral panel's decision directing the beneficiary to cancel the beneficiary's independent guarantees. Finally, this part will argue that the district court's ruling negatively impacts the commercial vitality of counter-guarantee/counter-standby arrangements because it raises the costs of these undertakings and undermines the utility of counter-guarantees/counter-standbys as security devices in support of locally-issued independent guarantees/standbys.

I. The Case

In *American Express Bank Ltd. v. Banco Espanol de Credito*, the District Court for the Southern District of New York was asked to analyze what impact, if any, a foreign arbitral award canceling the beneficiary's independent guarantees as part of dispute resolution over performance of the underlying contract should have on the rights and obligations of the beneficiary, the bank that issued the counter-guarantee, and the local bank beneficiary of the counter-guarantee/issuer of the local undertaking.[32] The development of joint ventures with the advent of globalization has resulted in greater willingness to submit to international commercial arbitration[33] so that arbitration has become "by far the favoured method of dispute settlement in international trade" with major international supply and construction contract containing arbitration clauses.[34] In light of this trend and the fact that the State of New York is the pre-eminent jurisdiction for development of letters of credit law, the district court's ruling in this case has the potential to significantly impact the counter-guarantee/counter-standby letter of credit legal landscape.[35]

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[32] 597 F. Supp 2d. 399–400 (S.D.N.Y. 2009).

[33] Christine Lecuyer-Thieffry and Patrick Thieffry, *Negotiating Settlement of Disputes Provisions in International Business Contracts: Recent Developments in Arbitration and Other Processes*, 45 BUS. LAW. 577, 578 (1990).

[34] Hussain M. Al-Baharna, *International Commercial Arbitration in Perspective*, 3 ARAB L.Q. 3, 4 (1988).

[35] *See supra* note 28.

A. Facts and Legal Proceedings Leading up to the Case

This case is ultimately the fallout of a dispute over a construction contract in a developing country. In 1995, a government entity of Pakistan, the Pakistan Water and Power Development Authority ("WAPDA") and Isolux Wat S.A. ("Isolux") entered into a USD 35 million contract for the construction of two electrical power stations in Pakistan.[36] WAPDA ("Beneficiary") is a semi-autonomous agency of the government of Pakistan responsible for coordinating infrastructure development projects in the water and power sectors. Isolux ("Applicant") is an engineering firm from Spain.[37] To secure Applicant's performance, Beneficiary required the engineering company to procure two independent (demand) guarantees in its favor. Applicant requested Banco Espanol de Credito ("Counter-Guarantor") located in Spain to issue the independent guarantees in favor of Beneficiary in Pakistan.[38] The condition for payment under the independent guarantees was the presentation of a written declaration of default. Counter-guarantor in turn requested the Pakistan branch of American Express Bank ("Local Bank") to execute the independent guarantees in favor of Beneficiary, whereby Counter-Guarantor would reimburse Local Bank for honoring the Beneficiary's independent guarantees upon a presentation complying with the terms of the counter-guarantee.[39] Thus, Counter-Guarantor issued a counter-guarantee in favor of Local Bank.[40] Specifically, the language of the counter-guarantee stated that Counter-Guarantor undertook to pay Local Bank on its "first demand notwithstanding any contestation from us or our applicants part [sic] or third party."[41]

1. Contract Arbitration Clause

In addition to arranging for independent guarantees and the counter-guarantee, Beneficiary and Applicant inserted an arbitration clause in their contract. The clause provided that "any difference, dispute or question arising out of or with reference to this agreement which cannot be settled

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[36] *American Express*, 597 F. Supp. 2d at 400.

[37] *Id.*

[38] *Id.*

[39] *Id.* at 398.

[40] *Id.* at 397–98.

[41] *Id.* at 398.

amicably . . . shall within 60 days from the date that either party informs the other in writing that such difference [,] dispute or question exists, be referred to arbitration of three arbitrators" and that "[t]he award of the majority of the [arbitrators] shall be final and binding on both parties."[42] Importantly however, the terms of neither the independent guarantees nor the counter-guarantee featured the outcome of arbitration in favor of Beneficiary as a condition for the fulfillment of obligations under the independent guarantees and the counter-guarantee.[43]

2. The Underlying Contract Dispute and the Subsequent Unraveling

By 2004, a dispute arose between Applicant and Beneficiary over Applicant's performance.[44] While the district court did not explain the details of the dispute, apparently Beneficiary wanted Applicant to complete repairs on the power stations.[45] On February 11, 2004, Applicant submitted a request for arbitration to the ICC International Court of Arbitration.[46] Applicant sought money damages and an order requiring Beneficiary to return all the guarantees issued in connection with the construction contract. At the same time Applicant obtained a preliminary injunction from the Spanish court to prevent Counter-Guarantor from honoring Local Bank's counter-guarantee.[47] Five months later, Beneficiary informed Local Bank that Applicant failed to perform and demanded payment under the independent guarantees.[48] Fearing it would not be reimbursed due to the injunction issued by the Spanish court, Local Bank sent Counter-Guarantor

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[42]*American Express*, 597 F. Supp. 2d at 397.

[43] The language of the independent (demand) guarantees required Local Bank "to pay [Beneficiary] without delay upon [Beneficiary's] first written request any amount claimed by [Beneficiary] upto [sic] the sum named herein, against [Beneficiary's] written declaration that [Applicant] refused or failed to perform the aforementioned contract."*American Express*, 597 F. Supp. 2d at 398. Per the text of the counter-guarantee, Counter-Guarantor undertook "to pay to [Local Bank] on [Local Bank's] first demand notwithstanding any contestation from us or our applicants part [sic] or third party." *Id.*

[44] *American Express*, 597 F. Supp. 2d at 399.

[45] *See* CFI, April 12, 2004 (R.J., No. 286/04-9), Walker Decl. Ex. H at 13.

[46] *American Express*, 597 F. Supp. 2d at 399.

[47] *See* CFI, April 12, 2004 (R.J., No. 286/04-9), Walker Decl. Ex. H at 13.

[48] *American Express*, 597 F. Supp. 2d at 399.

a SWIFT message demanding payment under the counter-guarantees.[49] Citing the Spanish court's injunction, Counter-Guarantor refused.[50] In February 2005, Beneficiary filed an action in Pakistan against Local Bank to recover on its independent guarantees.[51] On February 6, 2007, the ICC arbitral panel ruled in favor of Applicant and determined that Beneficiary owed Applicant approximately USD 788,066, while Applicant owed Beneficiary nothing. Importantly, the ICC arbitral panel ordered Beneficiary to cancel the two independent guarantees.[52] Undeterred by the arbitral panel's decision, Beneficiary continued its efforts to enforce its independent guarantees in Pakistan. As of the date of district court's written opinion, the Pakistani court had not yet ruled on Beneficiary's challenge to the ICC award.[53] Before the arbitral panel issued its decision, Local Bank filed a suit in the Southern District of New York and moved for summary judgment. In anticipation of having to pay on its local undertakings to Beneficiary, Local Bank sought to enforce Counter-Guarantor's obligation to reimburse it.[54] In the alternative, Local Bank sought a declaratory judgment that it would be entitled to payment from Counter-Guarantor if Local Bank is ordered to pay Beneficiary by the Pakistani court.[55]

As a threshold matter, the district court concluded that the independent guarantees and the counter-guarantee at issue are governed by letter of credit law because they share defining characteristics of standbys: the essential feature of independence and the "parties' expectation that [Beneficiary] would receive money promptly if it submitted a facially valid certification that [Applicant] failed to perform its obligations."[56]

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[49] *Id.* at 399–400.

[50] *Id.* at 400.

[51] *Id.*

[52] *Id.*

[53] *American Express*, 597 F. Supp. 2d at 406.

[54] *Id.* at 400.

[55] *Id.*

[56] *American Express*, 597 F. Supp. 2d at 402.

B. The Decision and Holding

The district court held that the ICC award had conclusively established the rights and liabilities of Beneficiary and Local Bank until such time as Beneficiary succeeded in vacating or modifying the arbitral award.[57] According to the district court, the ICC award precluded Beneficiary's continued demands for payment because in light of the award, under N.Y. UCC § 5-109, the letters of credit fraud provision, payment under Beneficiary's independent guarantees would facilitate "material fraud."[58] Consequently, according to the district court, Local Bank had no obligation to pay under its independent guarantees and no good faith basis to demand payment on its counter-guarantee issued by Counter-Guarantor.[59] The district court thus determined that under such facts Counter-Guarantor's refusal to honor Local Bank's presentation was proper because under Rev. UCC § 5-109 (Fraud and Forgery) as adopted verbatim by New York as state law neither Beneficiary nor Local Bank had a "colorable right" to demand the honor of the independent guarantees and the counter-guarantee, respectively.[60] Moreover, the district court refused to grant Local Bank's request for declaration that it would be entitled to reimbursement by Counter-Guarantor should a Pakistani court force it to honor the independent guarantees. In light of the fact that the Pakistan court has not yet ruled on Beneficiary's request to enforce the independent guarantees, the district court deemed such a claim not to be presently justiciable.[61] Thus, the district court dismissed Local Bank's entire motion for summary judgment without prejudice.[62]

C. The Court's Reasoning

The district court explained that in light of the ICC award against Beneficiary canceling Beneficiary's independent guarantees, Beneficiary's

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[57] *Id.* at 404.

[58] *Id.* at 403.

[59] *Id.* at 404.

[60] *See* N.Y. U.C.C. § 5-109 (McKinney 2006); Rev. U.C.C. § 5-109 (1995) (Fraud and Forgery).

[61] *American Express*, 597 F. Supp. 2d at 405–06.

[62] *Id.* at 406.

demand for payment under the independent guarantees and Local Bank's demand for payment under its counter-guarantee lacked any basis in law or fact under contract law, international law and New York law.[63] The court intimated that honoring of such a demand would thus facilitate letter of credit fraud by Beneficiary under New York's verbatim adoption of Rev. UCC Article 5 − N.Y. UCC § 5-109.[64]

1. Contract Law

The district court held that contract law fully and firmly established the rights and obligations of Beneficiary. First, the court reasoned that per the arbitration clause included in the contract signed by both Beneficiary and Applicant, the award of the ICC arbitral panel was "final and binding on both parties."[65] The district court further pointed out that courts adhere to the principle that the "scope of authority of arbitrators generally depends on the intention of the parties to an arbitration, and is determined by the agreement or submission."[66] Thus the court concluded that contract law precluded Beneficiary from demanding payments under its independent guarantees because it contracted for final and binding arbitration.[67]

2. International Law

The district court also determined Beneficiary's continued demands for payment under the independent guarantees to be inconsistent with the 1958 United Nations Convention on the Recognition and Enforcement of Arbitral Awards ("The New York Convention").[68] Thus, the court reasoned that the ICC arbitral award was also final and binding under the New York

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[63] *American Express*, 597 F. Supp. 2d at 403.

[64] *Id.*

[65] *Id.* at 404.

[66] Synergy Gas Co. v. Sasso, 853 F.2d 59, 63 (2d Cir. 1988) (citing Ottley v. Schwartzberg, 819 F.2d 373, 376 (2d Cir. 1987)).

[67] *See American Express*, 597 F. Supp. 2d at 403 ("WAPDA's continued demands for payment are flatly inconsistent with its contractual obligations.").

[68] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, Art. III, June 10, 1958, 330 U.N.T.S. 3 [hereinafter New York Convention] ("[e]ach Contracting State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon.").

Convention, to which Pakistan was a party.[69] Moreover, the court adopted one commentator's view that "the principle that a valid determination, either judgment or award, produces a conclusive effect with regard to the subject matter and the parties of the dispute constitutes a fundamental legal principles embedded in every legal system."[70] Thus the court concluded that the arbitral award here was res judicata − i.e. produced an ultimate non-reviewable legal outcome on the issue of Beneficiary's rights under its independent guarantees.[71]

3. New York Law

Finally, according to the court, New York law recognized the final and conclusive nature of international arbitral awards on parties who participated in such proceedings.[72] In support of its contention, the court cited *Guard-Life Corporation v. S. Parker Hardware Manufacturing Corporation*.[73] In that case, the New York Court of Appeals held that the plaintiff was bound by the outcome of the arbitration proceedings under the principles of issue preclusion and collateral estoppel.[74] The Court of Appeals reasoned that these principles applied because the plaintiff agreed to resolution of disputes arising under the contract by arbitration in Japan.[75] Presumably in the present case, issue preclusion and collateral estoppel bound Beneficiary by the outcome of the ICC award even more so since that the arbitration clause was part of its contract with Applicant.

4. Payment under the Independent Guarantee Would Violate N.Y. UCC § 5-109

The district intimated that in light of the res judicata nature of the ICC arbitral award against Beneficiary, any honor of Beneficiary's demand

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[69] *American Express*, 597 F. Supp. 2d at 403.

[70] Stavros Brekoulakis, *The Effect of An Arbitral Award and Third Parties in International Arbitration: Res Judicata Revisited*, 16 AM. REV. INT'L ARB. 177, 179 (2005).

[71] *Id.*

[72] *American Express*, 597 F. Supp. 2d at 403.

[73] 428 N.Y.S.2d 628 (N.Y. 1980).

[74] *Id.* at 635.

[75] *Id.*

under the independent guarantees "would facilitate a material fraud by the beneficiary on the issuer or applicant."[76] The district court cited a number of international construction cases that considered the letter of credit fraud standard and whether an injunction to prevent honor was warranted.[77] The court relied on these cases to show that it was appropriate to preclude payment under Local Bank's counter-guarantee and Beneficiary's independent guarantees when the contract dispute arbitral award directed Beneficiary to cancel its independent guarantees because the situation here fell under the general understanding of what constitutes "material fraud by the beneficiary."[78] The district court did not elaborate on how the cases it cited in support of its holding applied to the facts at hand.

II. Analysis

This section argues that the district court's holding lacks basis in standard international letter of credit practice, contract law, international law, New York law, case law-developed standard for issuing injunctions, and policy. First, this section will demonstrate that the court incorrectly concluded that the ICC arbitral award precludes Local Bank's and Beneficiary's continuous demand for payment of their respective undertakings under contract law, international law, and New York law. Second, this section will show that the court failed to observe the independence of counter-guarantees/counter-standbys from the local undertakings. Third, this section will show that the court's affirmation of the ICC arbitral panel's decision to cancel Beneficiary's independent guarantees and the injunction to prevent payment under the counter-guarantee is not in accord with the legal standard developed by United States federal and state courts for issuing injunctions to prevent letter of credit fraud. Last but not least, this section will argue that the district court's holding hurts the utility of counter-guarantees and counter-standbys for enabling international infrastructure projects.

[76] N.Y. U.C.C. § 5-109(b) (McKinney 2006).

[77] *American Express*, 597 F. Supp. 2d at 404. For citation to and parenthetical summary of a number of these cases *see supra* Part II.F., note 124.

[78] N.Y. U.C.C. § 5-109(b) (McKinney 2006); Rev. U.C.C. § 5-109(b) (1995) (Fraud and Forgery); *American Express*, 597 F. Supp. 2d at 403.

A. District Court's Ruling Conflicts with Letters of Credit Law and Practice

1. Validity of Beneficiary's Demand under International Law and Contract Law

The district court erroneously concluded that honoring the independent guarantees in light of the ICC arbitral award conflicts with the stipulation of the underlying contract's arbitration clause that the arbitral award is "final and binding on both parties."[79] In determining that Beneficiary's continued demand for payment is inconsistent with the arbitration clause of the underlying contract, the court relied on the proposition in *Synergy Gas Corporation v. Sasso* that the "scope of authority of arbitrators generally depends on the intention of parties to an arbitration, and is determined by agreement or submission."[80] However, the district court did not acknowledge that the same case points out that section 10 of the Federal Arbitration Act provides that an arbitral award can be vacated "[w]here the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter was not made."[81] Moreover, under the Private International Law Statute of Switzerland which governed the ICC arbitration, the arbitral award may be annulled "[i]f the Arbitral Tribunal's decision went beyond the claims submitted to it, or failed to decide one of the items of the claim."[82] Thus, when the arbitrators rule on a matter beyond the scope of the underlying contract, that part of their decision is invalid for lack of adjudicative authority. If an arbitral panel's ruling is *ultra vires*, the ruling's res judicata effect is irrelevant.

Similarly, in concluding that Beneficiary's continued demand for payment under the independent guarantees is inconsistent with its ratification of the New York Convention, the district court did not evaluate Article III of the convention in light of Article V. Under Article III, States shall recognize arbitral awards as binding and enforce them subject "to the conditions laid down in the following article."[83] According to Article V-

[79] *American Express*, 597 F. Supp. 2d at 403.

[80] *Id.* (citing Synergy Gas Co. v. Sasso, 853 F.2d 59, 63–64 (2d Cir. 1988)).

[81] *Synergy Gas Co.*, 853 F.2d at 63 (citing 9 U.S.C. §10(a)(4)).

[82] Cadarso Decl. Ex. C at 7 (citing Private International Law Statute art. 190(1)(c)(1987)).

[83] New York Convention, *supra* note 68.

1(c), "recognition and enforcement of the award may be refused" if "[t]he award deals with a difference not contemplated by *or not falling within the terms of the submission, or it contains decision on matters beyond the scope of the submission to arbitration* . . ."[84] Thus, just like the Private International Law Statute of Switzerland and the Federal Arbitration Act, the New York Convention also renders unenforceable arbitral awards on issues the arbitral panel had no authority to address under the underlying contract.

The district court's reliance on the ruling of the ICC arbitral panel on the dispute between Applicant and Beneficiary over the underlying construction contract cannot serve as a basis for not enforcing Counter-Guarantor's obligations with respect to Local Bank under both contract law and the New York Convention.

First, under the arbitration clause of the underlying contract, while the arbitral panel was free to determine the rights and obligations of Applicant and Beneficiary with respect to each other, based on the independence principle, the panel's decision did not affect Local Bank's obligations with respect to the independent guarantees and Counter-Guarantor's obligations with respect to the counter-guarantee. Under the independence principle the obligations to Beneficiary under the independent guarantees were separate and distinct from "performance or non performance of a contract" between "the applicant and the beneficiary."[85] Since the arbitration clause was part of the contract between Applicant and Beneficiary, per the independence principle[86] neither Counter-Guarantor nor Local Bank were in any way concerned with or bound by such contract. Indeed, if a beneficiary's ability to obtain funds under its locally-issued independent guarantees is made contingent on submission of arbitral or judicial award establishing whether the local beneficiary breached the contract, the independence principle loses practical significance and the purportedly "independent" guarantee in question starts to closely resemble the traditional suretyship or accessory guarantee.[87]

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[84] New York Convention, *supra* note 68, art. V-1(c) (emphasis added).

[85] N.Y. U.C.C. § 5-103(d) (McKinney 2006); Rev. U.C.C. § 5-103(d) (1995) (Scope).

[86] *See supra* note 7.

[87] *See* BERTRAMS, *supra* note 2, at 11.

Second, under the New York Convention, the status of Local Bank's obligations under Beneficiary's independent guarantees and Counter-Guarantor's obligations under Local Bank's counter-guarantee, respectively, did not fall "within the terms of the submission to arbitration."[88] While Applicant was in a contractual relationship with Counter-Guarantor to arrange for the issuance of the independent guarantees, Local Bank was not in privity with Applicant and was not a party to the arbitration clause in the underlying contract between Applicant and Beneficiary. Similarly, under the counter-guarantee/counter-standby structure, the local beneficiary acts without any contractual relationship to the counter-guarantor/issuer of counter-standby.[89] Accordingly, the ICC arbitral panel's decision directing Beneficiary to cancel its independent guarantees could not have voided Local Bank's obligations to honor a complying presentation under Beneficiary's independent guarantees and Counter-Guarantor's obligations to honor Local Bank's complying presentation under Local Bank's counter-guarantee, respectively. If the arbitral panel's decision to cancel the independent guarantees were to have such an effect, the panel's decision would not be in conformity with the New York Convention's Article V-1(c) because the panel's decision would have "contain[ed] decisions on matters beyond the scope of the submission to arbitration."[90] Thus, the fact that the ICC arbitral panel ruled in favor of Applicant cannot serve as one of the legal bases for upholding Counter-Guarantor's refusal to honor the counter-guarantee.[91]

Third, also in conflict with the independence principle, the district court failed to appreciate the independence of a local independent guarantee from a corresponding counter-guarantee when it held that Local Bank also has "no good faith basis" to demand honor of its counter-guarantee, until the arbitral award is modified or vacated.[92] The independence principle in counter-guarantee/counter-standby context means that defenses originating from the local undertaking are not available to the counter-guarantor/issuer

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[88] New York Convention, *supra* note 68, art. V-1(c).

[89] *See* BERTRAMS, *supra* note 2, at 18−19.

[90] *Id.*

[91] Rev. U.C.C. § 5-109(b) cmt. 1 (1995) (Fraud and Forgery).

[92] *American Express*, 597 F. Supp. 2d at 404; *see* 2010 ANNUAL REVIEW OF INTERNATIONAL BANKING LAW & PRACTICE 430−31 (2010) [hereinafter 2010 ANNUAL REVIEW].

of counter-standby.[93] The counter-guarantee/counter-standby is payable in accordance with its own terms.[94] The language of the counter-guarantee here stated that it is payable "on your first demand notwithstanding any contestation from us or our applicants part [sic] or third party."[95] Thus, Local Bank's counter-guarantee was a "first demand" type of independent undertaking, also referred to as "clean" or "suicide" guarantee.[96] Under a "first demand" guarantee no documentation of the applicant's default is required and a bare demand for payment, usually by presenting a sight draft, is sufficient. Therefore, a "first demand" guarantee is the riskiest type of independent undertaking from the vantage point of counter-guarantor/issuer of counter-standby because documentary certification of default which can offer more protection to counter-guarantor/issuer of counter-standby is not available.[97] Indeed, courts rely on false certification as a ground for court-ordered injunctive relief to prevent letter of credit fraud.[98] It is true that a "written declaration that [Applicant] has refused or failed to perform the aforementioned contract" was the condition for honoring the local independent guarantees.[99] However, the only term for payment under the counter-guarantee, by contrast, was that Beneficiary make a bare demand for payment. Moreover, the language of the counter-guarantee was absolute – "notwithstanding any contestation from us or our applicants part [sic] or third party." Thus, the independence principle should have insulated Local Bank's ability to draw on the counter-guarantee from the controversy over Beneficiary's right to draw on the local independent guarantees. Since a written certification of default was not one of the terms of the counter-

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[93] *See supra* note 23; BERTRAMS, *supra* note 2, at 3.

[94] BERTRAMS, *supra* note 2, at 196.

[95] *American Express*, 597 F. Supp. 2d at 398.

[96] BERTRAMS, *supra* note 2, at 13; Barru, *supra* note 1, at 64–65.

[97] BERTRAMS, *supra* note 2, at 13; Barru, *supra* note 1, at 64–65.

[98] *See, e.g.*, Brenntag Int'l Chem. Inc. v. Bank of India, 175 F.3d 245, 249, 251 (2d Cir. 1999) (affirming an injunction to prevent negotiating bank from collecting payment under the standby based on letter of credit fraud, reasoning that the default the "default letter" purported to certify had not and could not have occurred at the time the letter was written; court concluded that despite having actual knowledge that applicant was not in default, the negotiating bank nonetheless date-stamped the original undated default letter signed by a party not authorized to sign on behalf of beneficiary and attempted to collect payment under the standby using the materially inaccurate and non-compliant default letter).

[99] *American Express*, 597 F. Supp. 2d at 398.

guarantee, Local Bank could not have logically been falsely certifying as to Applicant's default in light of the ICC arbitral award in favor of Applicant. In other words, the pending action by Beneficiary against Local Bank in Pakistani courts to enforce the local independent guarantees furnished Local Bank with a "colorable right" to draw on the counter-guarantee.[100] The reason Local Bank had a "colorable right" is that in contrast to the terms of the local independent guarantees, the counter-guarantee did not require the submission of written certification of Applicant's default as one of its terms. The only way Local Bank's "first demand" for payment under the counter-guarantee would have "lack[ed] any basis in law or fact"[101] was if the court in Pakistan issued a final ruling against Beneficiary, denying Beneficiary's request to force Local Bank to honor Beneficiary's independent guarantees.[102]

2. Validity of Beneficiary's Demand under New York Law

In addition to being poorly grounded in contract law, international public law, and standard international letter of credit practice, the district court's conclusion that in light of the ICC arbitral award Beneficiary and Local Bank "lack[] any basis in law and fact" to demand payment under the local guarantees and counter-guarantee, respectively, clashes with New York case law. In *Banco Nacional De Mexico, S.A. v. Societe Generale*,[103] a case that closely resembles the situation here, the local bank honored the Mexican government infrastructure agency's demand under the standby letters of credit.[104] A contractual dispute between the applicants and the Mexican beneficiary arose and the two commenced arbitration.[105] Meanwhile, the applicants obtained a provisional injunction to prevent the issuing bank from honoring the standby.[106] The confirming bank subsequently sued the issuer to obtain reimbursement for honoring the

[100] *See* 2010 ANNUAL REVIEW, *supra* note 91, at 430–31.

[101] *American Express*, 597 F. Supp. 2d at 403.

[102] *See* 2010 ANNUAL REVIEW, *supra* note 91, at 430–31.

[103] Banco Nacional De Mexico, S.A. v. Societe Generale, 820 N.Y.S.2d 588 (N.Y. App. Div. 2006).

[104] *Banco Nacional De Mexico*, 820 N.Y.S.2d at 588.

[105] *Id.*

[106] *Id.* at 589.

Mexican beneficiary's standby.[107] The New York State Supreme Court, Appellate Division, held that under New York law, the issuing bank must honor a complying presentation regardless of whether there is a dispute concerning the underlying contract.[108] The court explained that in accordance with the independence principle, the standby created a relationship between the issuing bank and the confirming bank, which was separate and independent of the underlying transaction in Mexico between the beneficiary and the applicant. The court further reasoned that payment under the standby to the beneficiary was not conditioned on any "arbitral award" and that the written request for payment to the issuer under the standby strictly conformed to the documentary conditions of the standby.[109]

Here just as in *Banco Nacional De Mexico*, the outcome of arbitration was neither one of the conditions for payment under the local independent guarantees nor under the counter-guarantee.[110] Thus, similar to the beneficiary in *Banco Nacional De Mexico*, as long as Beneficiary and Local Bank strictly complied with the terms of their respective undertakings, i.e. − by submitting facially valid certification that Applicant failed to perform its obligations in the case of Beneficiary and by making a bear demand in the case of Local Bank, under New York law, the outcome of the ICC arbitration should have had no bearing on the right to draw on either undertaking.

B. Injunction to Prevent "Material Fraud" under Rev. UCC § 5-109

In holding that Beneficiary had no "colorable right" to demand payments under its local independent guarantees and Local Bank had "no good faith basis" to demand payment under the counter-guarantee, the district court effectively affirmed the injunction of the Spanish Court to prevent Issuer from honoring the counter-guarantee and the ICC arbitral panel's cancellation of Beneficiary's local independent guarantees.[111] Indeed, the district court's holding cited Official Comment 1 to Rev. UCC § 5-109 which states that "material fraud by the beneficiary occurs only when

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[107] *Id.*
[108] *Id.* at 591.

[109] *Banco Nacional De Mexico*, 820 N.Y.S.2d at 591.

[110] *See supra* Part I.A.

[111] American Express Bank, Ltd. v. Banco Espanol de Credito, 597 F. Supp 2d. 394, 403 (S.D.N.Y. 2009).

the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor."[112] Upon a finding of "material fraud", Rev. UCC § 5-109(b) grants a court of competent jurisdiction the right to issue an injunction to prevent the honoring of a letter of credit. In reaching its conclusion, however, the district court failed to observe the case law standard for issuing injunctions to prevent banks from paying on letters of credit on the grounds of fraud. Indeed, the district court affirmed the injunction to prevent the honor of the counter-guarantee and the arbitral award canceling the local guarantees solely on the basis of the "likely to succeed on the merits" prong. The district court concluded that the drawdown on the counter-guarantee would facilitate material fraud within the meaning of Rev. UCC § 5-109 but the court did not analyze whether absent the injunction Applicant would suffer "irreparable harm".

1. Legal Standard for Issuing Injunction to Prevent Letter of Credit Fraud

The party seeking an injunction to prevent payment under a letter of credit has to establish that honoring the credit would facilitate material fraud.[113] The landmark United States case that launched the development of the letter of credit fraud doctrine is *Sztejn v. Henry Schroeder Banking Corp*.[114] That case "has . . . been codified in the Uniform Commercial Code ("UCC") and followed by nearly all subsequent letter of credit fraud cases in the United States."[115] In *Sztejn*, the underlying contract was for bristles. The beneficiary, however, instead shipped the merchandise "not merely of inferior quality but [that] consists of worthless rubbish."[116] The court held that the bank, which had been given notice of the beneficiary's fraud, was thus justified in refusing to honor the beneficiary's demand under the letter of credit.[117]

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[112] *Id.* at 403.

[113] *Brenntag Int'l*, 175 F.3d 249–51; *Itek Corp. v. The First Nat'l Bank of Boston*, 730 F.2d 19, 24–25 (1st Cir. 1984).

[114] 31 N.Y.S.2d 631 (N.Y. Sup. Ct. 1941).

[115] Ross P. Buckley and Gao Xiang, *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, 676 (2002).

[116] *Sztejn*, 31 N.Y.S.2d at 634–35.

[117] *Id.*

The exception created by *Sztejn* for fraud in the transaction has been recognized and adopted by courts in England,[118] and codified in UCC § 5-114.[119] Rev. UCC § 5-109 is the modern formulation of fraud which replaced UCC § 5-114.[120] While § 5-109 still allows relief if fraud is present in the underlying transaction, the revised fraud provision adds the qualification that to trigger court review there must be an allegation of "material fraud."[121] In essence, under Rev. UCC § 5-109, an applicant claiming that "a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant" is able to seek relief through enjoining the issuing bank from paying on the letter of credit.[122] Moreover, under that provision the counter-guarantor/issuer of counter-standby may refuse to honor the local bank's presentation, if the local bank honored its local undertaking not in good faith − i.e. with "notice of forgery and material fraud."[123]

United States courts have struggled to develop guidelines for determining when a conduct constitutes letter of credit fraud and is serious enough and clear enough to warrant injunctive relief.[124] However, finding

[118] *See* United City Merchants Ltd. v. Royal Bank of Canada, [1979] 1 Lloyd's L.R. 267, 276; R.D. Harbottle Ltd. v. Nat. Westminster Bank, [1977] 1 Q.B. 146, 156.

[119] U.C.C. § 5-114(2) (1978) (Issuer's Duty and Privilege to Honor; Right to Reimbursement).

[120] Rev. U.C.C. § 5-109 cmt. 1 (1995); Buckley and Xiang, *supra* note 115, at 684−85.

[121] Rev. U.C.C. § 5-109 cmt. 1 (1995); Rev. U.C.C. § 5-109 cmt. 3 (1995) ("If the applicant were able to show that the beneficiary were committing material fraud on the applicant in the underlying transaction, then payment would facilitate a material fraud by the beneficiary on the applicant and honor could be enjoined.").

[122] *Id.* § 5-109(b).

[123] *See id.* § 5-109(a) (2).

[124] *See, e.g.,* Brenntag Int'l Chem. Inc. v. Bank of India, 175 F.3d 245, 251 (2d Cir. 1999) (holding that a nominated bank committed letter of credit fraud warranting injunction when it presented the issuing bank with a facially invalid default certificate which the nominated bank produced by date-stamping the undated long-held original default letter, thus making the applicant's default occur a full year prior to the earlier possible date of default under the standby, and by having the default letter be signed by a party not authorized to sign on behalf of beneficiary); Rockwell Int'l Sys., Inc. v. Citibank, N.A., 719 F.2d 583, 589 (2d Cir. 1983) (decided under Prior U.C.C. Article 5) (explaining that "the 'fraud' inheres in first causing the default and then attempting to reap the benefits of the guarantee" and granting an injunction to prevent issuing bank from honoring confirm bank's demand under

that honoring the beneficiary's presentation would facilitate material fraud is not by itself sufficient for courts to enjoin a bank from paying on the independent undertaking. To justify injunctive relief the party seeking an injunction must demonstrate that: (i) it will suffer "irreparable harm" absent the injunction; and (ii) that the party is either (a) likely to succeed on the merits or (b) there exist sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tips decidedly in favor of the moving party.[125] The finding of material fraud can only satisfy the "success on the merits" prong of the injunction test.[126]

Courts have also worked to flesh out the "irreparable harm" element of the injunction test. In general terms, a party is irreparably harmed "where, but for the grant of equitable relief, there is a substantial chance that upon final resolution of the action the parties cannot be returned to the positions they previously occupied."[127] Specifically, courts find "irreparable

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the counter-standbys); Roman Ceramics Corp. v. Peoples Nat'l Bank, 714 F.2d 1207 (3d Cir. 1983) (decided under Prior U.C.C. Article 5) (adopting the principle that the circumstances which will justify an injunction against honor must be narrowly limited to situations "in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purpose of the independence of the issuer's obligation would no longer be served" and on the basis of this formulation holding that an intentional and knowing submission by the beneficiary of documents with the intention of drawing on the letter of credit so as to be paid twice for the invoices has "no basis in fact" and thus rises to the level of fraud warranting an injunction); *cf.* 3Com Corp. v. Banco do Brasil, 171 F.3d 739, 747–48 (2d Cir. 1999) (holding that the beneficiary presenting invoices that were in the name of, and for goods shipped to the applicant's purchasing agent, rather than the applicant itself pursuant to terms of the standby did not constitute an "outright fraudulent practice" because the applicant had unconditionally guaranteed agent's obligations to the beneficiary and waived any right to require the beneficiary to proceed against the agent rather than the applicant directly); Ground Air Transfer, Inc. v. Westates Airlines, Inc., 899 F.2d 1269 (1st Cir. 1990) (decided under Prior U.C.C. Article 5) (holding that a beneficiary does not act fraudulently as long as the record indicates that the beneficiary's demand for payment under the standby letter of credit is at least "colorable" and not obviously without merit); Recon/Optical, Inc. v. Government of Israel, 816 F.2d 854 (2d Cir. 1987) (decided under Prior U.C.C. Article 5) (denying an injunction to prevent beneficiary from drawing on a standby on the grounds that the drawdown by the beneficiary would not rise to the level of "fraud in the transaction" given that the beneficiary did not cause the applicant to interrupt the performance of the construction contract.).

[125] *Brenntag Int'l*, 175 F.3d at 249–50; *Rockwell Int'l Sys.*, 719 F.2d at 586; Lentjes Bischoff GmbH v. Joy Envtl. Techs., Inc., 986 F. Supp. 183, 185–86 (S.D.N.Y. 1997).

[126] *Brenntag Int'l*, 175 F.3d 249–51; *Itek Corp.*, 730 F.2d at 24–25.

[127] *Brenntag Int'l*, 175 F.3d at 249–50.

harm" warranting an injunction when the party that might have to pay monetary damages is insolvent, facing imminent bankruptcy, or in a perilous financial state.[128] United States courts also find "irreparable harm" warranting injunctive relief when absent the injunction the party seeking it would have no adequate remedy under law.[129] A party seeking an injunction may lack adequate legal remedy if the amount of monetary damages is difficult to establish.[130] A party also has no adequate legal remedy when "the very availability of a legal forum is called into question."[131]

Several cases provide an apt illustration of the "no adequate legal remedy" principle. In *Rockwell International Systems v. Citibank*, the applicant entered into a standby-backed contract with the beneficiary, the pre-revolutionary government of Iran, to provide engineering and advisory services.[132] The court granted the applicant injunction to prevent the issuing bank from honoring the local bank's counter-standby *inter alia* on the ground that the applicant would otherwise have no adequate relief under law. The court reasoned that resort to Iranian courts per the choice-of-forum terms of the contract would be futile in light of the collapse of justice

[128] *Brenntag Int'l*, 175 F.3d at 250 (holding that the district court correctly concluded that the beneficiary's insolvency, together with the weak claims of the applicant would have against the issuing or the confirming bank were a demand under the letter of credit errantly paid, was sufficient to bring this case within insolvency exception); Centauri Shipping Ltd. v. Western Bulk Carriers KS, 528 F. Supp.2d 186, 194 (S.D.N.Y. 2007) ("[M]onetary injury may suffice to establish irreparable harm in situations where the party that might ultimately be ordered to pay the monetary damages is insolvent or facing imminent bankruptcy, or is in a perilous financial state.").

[129] *Rockwell Int'l Sys.*, 719 F.2d at 586; *Itek Corp.*, 730 F.2d at 22; *Southern Energy Homes*, 709 So. 2d at 1187.

[130] JSG Trading Corp. v. Tray-Wrap, Inc., 917 F.2d 75, 79 (2d Cir. 1990) ("Irreparable injury is one that cannot be redressed through a monetary award. Where money damages are adequate compensation a preliminary injunction should not issue."); *Rockwell Int'l Sys.*, 719 F.2d at 586 ("We note, for example, that a remedy at law may be considered inadequate when the amount of damages would be difficult to prove.").

[131] *Rockwell Int'l Sys.*, 719 F.2d at 586; *see Itek Corp.*, 730 F.3d at 22 (holding that the applicant has no remedy under law for fraudulent drawdown of the letters of credit because *inter alia* in light of the Iranian Revolution and the resulting strained relations between the U.S. and Iran, applicant's efforts at post hoc monetary recovery through Iranian courts would be futile).

[132] 719 F.2d at 584.

administration in the wake of post-revolutionary turmoil in Iran and the strained relations between the new Iranian regime and the United States.[133]

In another international construction case, *American Bell International v. Islamic Republic of Iran*[134] triggered by the Iranian Revolution, the court held that the bank failed to show irreparable harm which would support the injunction. The court concluded that although attempts by the issuing bank to resort to Iranian courts would be futile, the bank did not demonstrate that it was without adequate remedy in New York courts against the Iranian defendants under the Foreign Sovereign Immunities Act.[135]

Similarly, in *Foxboro Co. v. Arabian American Oil Co.*,[136] the First Circuit Court held that the applicant failed to demonstrate irreparable harm as required to support preliminary injunction to prevent the local bank from paying under the counter-guarantee and the issuer of the counter-guarantee from paying the local bank in a "four-way" security arrangement. The court reasoned that the applicant had adequate remedy under law for harm done to it by the allegedly fraudulent demand because (i) it had several avenues open to recover any money due from the allegedly fraudulent demand including Saudi Arabian arbitration, international arbitration, an action in Saudi court and an action in Federal U.S. court; and (ii) the applicant had not demonstrated that the beneficiary of the local undertaking lacked sufficient assets in the U.S. or would be unwilling or unable to pay any judgment debt.[137]

Finally, in *Southern Energy Homes, Inc. v. AmSouth of Alabama*, the Supreme Court of Alabama held that the applicant did not meet the "irreparable harm" requirement for issuing an injunction on the exercise of the letter of credit. The court reasoned that the applicant could sue in a German court to recover money for the alleged fraud.[138] The court further

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[133] *Id.* at 588–89.

[134] 474 F. Supp. 420 (S.D.N.Y. 1979).

[135] *Id.* at 423.

[136] 805 F.2d 34 (decided under Prior U.C.C. Article 5).

[137] *Id*. at 36–37.

[138] 709 So. 2d at 1187–88.

reasoned that the applicant bargained for the advantages and disadvantages of the standby letter of credit and for the choice of forum provision.[139]

The requirement that the party seeking an injunction demonstrate that absent the injunction it would suffer irreparable harm is motivated by the need to interpret the fraud provision narrowly.[140] An injunction should be the option of the last resort because "examining the rights and wrongs of a contract dispute to determine whether a letter of credit should be paid risks depriving its beneficiary of the very advantage for which he bargained, namely that the dispute would be resolved while he is in possession of the money."[141] Indeed, Rev. UCC § 5-109 supports the notion that being an equitable remedy, injunctive relief is only appropriate when there is no adequate legal remedy.[142] The official commentary to Rev. UCC § 5-109 moreover recognizes that courts should have "hostility" towards the use of injunctions because their expanded use threatens the independence principle.[143]

2. The Court Failed to Evaluate Whether Absent an Injunction to Prevent the Honoring of Counter-Guarantee Applicant Would Have No Adequate Remedy Under Law.

Here, the district court solely focused on the results of the arbitration without analyzing whether Applicant would have an adequate remedy under law if Beneficiary was to illegitimately draw on its local independent guarantees and Applicant had to as a result reimburse Counter-Guarantor

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[139] *Id.*

[140] Itek Corp. v. The First Nat'l Bank of Boston, 730 F.2d 19, 24 (1st Cir. 1984).

[141] *Itek Corp.*, 730 F.3d at 24; *see also Southern Energy Homes*, 709 So. 2d at 1187 ("Clearly, a dispute exists between [the applicant] and [the beneficiary] based on the underlying contract . . . To invoke the fraud exception in this case would require an inquiry into the underlying contract, further disrupting the important commercial functions of credit law.").

[142] Rev. U.C.C. § 5-109(b) (1995) (Fraud and Forgery) ("If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons . . . .").

[143] *Id.* § 5-109 cmt. 5.

after Local Bank drew on its counter-guarantee.[144] However, there is all the reason to believe that Applicant would have adequate remedy under law if Beneficiary exercised its rights under its locally-issued independent guarantees. First, there would be no difficulty determining the precise calculation of pecuniary damages to Applicant. The ICC arbitral panel determined that Beneficiary owed Applicant approximately USD 788,066, and Applicant owed Beneficiary nothing.[145] In addition to this sum, should Beneficiary illegitimately draw on the local independent guarantees, it would owe Applicant the sum of the two independent guarantees totaling USD 1,778,571.50.[146]

Second, contrary to *Rockwell International Systems v. Citibank* where the court enjoined the issuing bank from honoring the confirming bank's demand on the counter-standbys, the government of Pakistan is not obviously hostile to the United States unlike the post-revolutionary government of Iran. In fact, Pakistan is a strategic partner of the United States in the "war on terrorism",[147] receiving arms transfers as well as billions of dollars in direct foreign aid.[148] Moreover, Pakistan's government is functioning and not in a state of turmoil akin to that of Iran during its 1979 Revolution.[149] Thus, unlike the situation in *Rockwell International Systems v. Citibank*,[150] Beneficiary country's judicial administration is presumably intact. This means that Applicant would be able to avail itself of Pakistan as a forum for obtaining damages under contract law and an attempt to use this forum would not be futile in the eyes of law.

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[144] *See American Express*, 597 F. Supp. 2d at 403 ("In view of the ICC award -- and as a question of basic contract law, international law, and New York law -- WAPDA's continued demands for payment of the guaranties lack any basis in law or fact. Thus, until the award is modified or vacated, neither WAPDA nor AEB has a 'colorable right' to demand honor of the guaranties or counter guaranties.").

[145] *Id.* at 400.

[146] *Id.* at 401.

[147] ALAN K. KRONSTADT, CONG. RESEARCH SERV., PAKISTAN AND TERRORISM: A SUMMARY, 2 (2007).

[148] *Id.* at 4–5.

[149] *See, e.g.*, Merle D. Kellerhals, Stability in Pakistan Is Central to U.S. Efforts in Afghanistan, AMERICA.GOV, Apr. 24, 2009, http://www.america.gov/st/peacesec-english/2009/April/20090424143251dmslahrellek0.3880884.html&distid=ucs.

[150] 719 F.2d at 586–88.

As in *American Bell International v. Islamic Republic of Iran*[151] in which the court denied an injunction on the exercise of standby letter of credit and in *Foxboro Co. v. Arabian American Oil Co.*[152] where the court denied preliminary injunction to prevent payment under the local guarantee and counter-guarantee, Applicant here may be able to avail itself of Spain or New York as adequate legal forums, if not Pakistan.[153]

Similar to *Southern Energy Homes, Inc. v. AmSouth of Alabama*,[154] Applicant in this case could try to recover for alleged fraud in Pakistan. Moreover, just like the applicant in *Southern Energy Homes*,[155] Applicant bargained for such a disadvantage of independent guarantees/standbys. Finally, while it is understandable that Applicant may not find the prospect of having to litigate in Pakistan particularly appealing given Pakistan's "history of instability and unreliable political and judicial systems"[156], Applicant may not have to be confined to this legal forum to successfully recover damages for fraudulently drawn local independent guarantees. Similar to *Foxboro Co. v. Arabian American Oil Co.*,[157] Applicant had not demonstrated that Beneficiary lacked sufficient assets in the United States or would be unwilling or unable to pay any judgment debt. Indeed, since Beneficiary is a government agency[158] there may be significant attachable

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[151]474 F. Supp. at 423, 427.

[152] 805 F. 2d 34, at 36–37 (1st Cir. 1986) (decided under Prior U.C.C. Article 5).

[153] *See* N.Y. Gen. Oblig. Law § 5-1401 (McKinney's 2001). New York permits its law to govern rights and obligations of parties to a contract from another country "whether or not such contract, agreement or undertaking bears a reasonable relation to this state." *Id.*; *American Express*, 597 F. Supp. 2d at 401.

[154] 709 So. 2d at 1187–88.

[155] *Id.* at 1887.

[156] Mark Kantor, *International Project Finance and Arbitration with Public Sector Entities: When is Arbitrability a Fiction?* 24 FORDHAM INT'L L.J. 1122, 1125–26 (2001).

[157] 805 F.2d at 37.

[158] *American Express*, 597 F. Supp. 2d at 397 ("WAPDA is a semi-autonomous agency of the government of Pakistan, which is responsible for coordinating infrastructure development schemes in the water and power sectors.").

assets outside of Pakistan.[159] Moreover, another promising avenue available to Applicant is the prospect of enforcing damage claims against receivables owing to the Pakistan government on account of export transactions. Additionally, third country enforcement prospects open up if Applicant-built power stations begin generating hard currency revenues. In essence, in order to recover for damages under contract law, Applicant would not necessarily have to litigate in Pakistan, but would need to prevail in any jurisdiction where there are attachable assets.

C. Vitality of Counter-Guarantees/Counter-Standbys as Commercial Device

1. Raises the Cost of Counter-Guarantees/Counter-Standbys

In addition to conflicting with standard international letters of credit practice and domestic law on issuing injunctions in case of letters of credit fraud, the district court's holding in *American Express Bank v. Banco Espanol de Credito* hurts the commercial utility of counter-guarantees/counter-standbys by raising the cost of these undertakings. First, in addition to the already existing layer of litigation between applicants and beneficiaries over the underlying contract, the *American Express* rule adds a second layer of litigation – litigation between beneficiaries and local banks and litigation between counter-guarantors/issuers of counter-standbys and local banks. Making the disputes over the underlying contract affect the relationships between financial institutions participating in counter-guarantee/counter-standby arrangements creates the need to enforce each party's rights and obligations through courts when an arbitral panel rules in favor of the applicant and cancels the beneficiary's local independent guarantees/standbys.

Here, Local Bank reinitiated its legal action against Counter-Guarantor in response to Beneficiary continuing its efforts to enforce Local Bank's obligations under the independent guarantees through Pakistani courts after the ICC arbitral panel ruled against Beneficiary and canceled Beneficiary's independent guarantees.[160] Thus, the very fact that Beneficiary sued Local Bank and Local Bank sued Counter-Guarantor in

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[159] *See* Kantor, *supra* note 156, at 1176 (discussing the advantages of enforcing awards against government entities of third world countries in contrast to enforcing awards against private obligors).

[160] *American Express*, 597 F. Supp. 2d at 400.

the aftermath of the arbitral panel's decision and the Spanish court's injunction to prevent the honoring of the counter-guarantee should have served as indication to the district court that refusal to enforce payment under the counter-guarantees/counter-standbys catalyzes litigation. However, by holding that in light of the arbitral award Beneficiary had no legitimate basis to demand payment and Local Bank consequently had no good faith basis to pay Beneficiary under the independent guarantees[161] the district court paved the way for increase in bank litigation. Under the *American Express* holding, local banks will refuse to honor the local independent guarantees/standbys when there is an injunction in place preventing the counter-guarantor/issuer of the counter-standby from honoring the local bank's counter-guarantee/counter-standby; or an arbitral award resolving the dispute over the underlying contract against the local beneficiary; or both. Under such a scenario, local beneficiaries will be motivated to resort to local courts to enforce their rights under the independent guarantees/standbys. If local courts rule in favor of the local beneficiary and force the local bank to pay under the independent guarantees/standbys and the counter-guarantor/issuer of the counter-standby refuses to honor the local bank's complying demand, the local bank will have to in turn initiate an action against the counter-guarantor/issuer of the counter-standby to obtain payment under its counter-guarantee/counter-standby. Indeed, as the district court acknowledged:

> Undeniably, this decision leaves AEB [Local Bank] in a difficult position. If Pakistan's courts order that AEB [Local Bank] honor the principal guaranties, AEB honors the guaranties, and Banesto [Counter-Guarantor] refuses to honor the counterguaranties or otherwise reimburse AEB [Local Bank], AEB [Local Bank] will be required to initiate a new action to recoup payment from Banesto [Counter-Guarantor].[162]

To compensate for increased risk of litigation with other banks and with the local beneficiary if a contractual dispute between the applicant and the beneficiary erupts, banks will charge higher fees for participating in the "four way" security arrangements consisting of local independent guarantees/standbys backed by counter-guarantees/counter-standbys or even

[161] Stern, *supra* note 8, at 235.

[162] *American Express*, 597 F. Supp. 2d at 406.

refuse to provide such services altogether for certain projects at the economic margin.[163]

The district court's rule also promises to raise the cost of resorting to counter-guarantees/counter-standbys by increasing the administrative expenses of banks involved in such arrangements. The independence principle provides banks with a significant advantage by reducing the bank's function to only a ministerial one: the bank is required to examine documents to determine whether on their face they comply with the terms of the letter of credit.[164] Thus, banks keep the costs of independent undertakings down by not having to engage in fact finding or in judgment making as to performance or non-performance of the underlying contract. However, in *American Express* the district court conditioned the ability of a local bank to get paid under its counter-guarantee/counter-standby on the outcome of arbitration proceedings over the underlying construction contract and thereby failed to observe the independence of counter-guarantees/counter-standbys from local undertakings. Such a rule gives local banks that issue independent-guarantees/standbys backed by counter-guarantees/counter-standbys an incentive to engage in investigation and monitoring of the underlying contract. Indeed, local banks would be motivated to look beyond the four corners of the document in order to minimize the risk of an injunction, the inability to obtain payment from counter-guarantors/issuers of counter-standbys and the resulting litigation with counter-guarantors/issuers of counter-standbys. To compensate for having to perform these functions local banks will naturally charge higher fees. Some local banks may even refuse to issue local undertakings backed by counter-guarantees/counter-standbys for certain projects altogether if the local banks perceive there is a serious risk they will not be able to obtain prompt payment under their counter-guarantees/counter-standbys prior to any litigation in case of a major contractual impasse between the applicant and the beneficiary.

The increase in cost associated with issuing independent guarantees/standbys that are backed by counter-guarantees/counter-standbys as a result of having to investigate and monitor the underlying contract may

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[163] *Cf.* Stern, *supra* note 8, at 239 (arguing that under "breach of contract" fraud standard, as issuing banks became involved in more litigation, their expense would be increased and this added cost would be passed on, in the form of higher fees, to those who use standby letters of credit).

[164] BERTRAMS, *supra* note 2, at 12; Barru, *supra* note 1, at 89.

be considerable because banks are ill equipped to handle the task.[165] Banks have a comparative advantage in "the business of banking, most of which involves paper work" and "cannot function properly if they are compelled to investigate and verify facts outside their normal business."[166] Indeed, applicants and beneficiaries are the least cost monitors of their underlying contract, not banks. Banks are not in control "of either the underlying transaction or the applicant's selection of the beneficiary."[167] The applicant and the beneficiary however are the experts in their field of business, just as Beneficiary, the Pakistani infrastructure development government agency, and Applicant, the Spanish engineering firm, are experts in international construction. Applicants and beneficiaries are thus in the best position to minimize the risk that the contract goes awry by shaping the terms of the contract. For instance, the parties may structure the independent guarantee/standby to afford applicants more protection. They can designate the terms of the independent guarantee/standby to require payment upon proper presentation of "statements from the beneficiary in the form of correspondence or certificates, or certificates from independent surveyors, especially from those nominated by the beneficiary, or from the engineer in the case of construction contracts" which the applicant could then present to the courts to prevent payment under the independent guarantee/standby based on a letter of credit fraud or breach of warranty claim.[168] Parties could also contract to make "initial orders in smaller lots until the good faith of international seller can be assured" or secure performance bonds "where the seller's creditworthiness or good faith is unknown."[169] Ultimately, local banks may pass the increase in administrative expenses associated with issuing independent guarantees/standbys backed by counter-guarantees/counter-standbys onto the beneficiaries and applicants in the form of higher fees for their services. This in turn will translate into

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[165] *See* Boris Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 331 (1982) ("Banks are only equipped to safely handle assurances of payment and not of completion of performance of underlying obligations. Not only do they lack the necessary expertise, but once the banks undertake the assurance of completion of performance they cannot escape the liability inherent in the innumerable trades or professions involved in such assurance.").

[166] Buckley & Xiang, *supra* note 7, at 122; *see* Kozolchyk, *supra* note 164, at 331.

[167] Buckley & Xiang, *supra* note 7, at 122.

[168] BERTRAMS, *supra* note 2, at 363; Barru, *supra* note 1, at 65.

[169] Mark S. Blodgett & Donald O. Mayer, *International Letters of Credit: Arbitral Alternative to Litigating Fraud*, 35 AM. BUS. L.J. 443, 460 (1998).

increase in the total cost of the underlying infrastructure project, reducing beneficial gains from joint ventures in the developing world.

2. Decreases Utility of Counter-Guarantees/Counter-Standbys as Security Devices

In addition to hurting the commercial vitality of counter-guarantees/counter-standbys by raising expenses of local banks and counter-guarantors/issuers of counter-standbys, the *American Express* rule decreases the commercial utility of counter-guarantees/counter-standbys by harming their ability to assure independent guarantees/standbys issued by a financial institution located within the beneficiary government's territorial jurisdiction. Counter-guarantees and counter-standbys are attractive as security devices in support of locally-issued independent undertakings precisely because in case of applicant's non-performance the local bank has assurance of prompt and certain payment from the counter-guarantor/issuer of counter-standby when faced with the prospect of having to honor a local independent guarantee/standby. Indeed, as a result of the independence principle payment will not be delayed by litigation or by the local bank's investigation into performance of the underlying contract.[170] By holding that a beneficiary has no "colorable right" to demand payments under its local guarantees and the local bank in turn has "no good faith basis" to demand payment under its counter-guarantees when an arbitral panel set up to resolve a dispute over the performance of the underlying contract rules against the beneficiary, the district court not only weakened the advantages of independent guarantees/standbys for beneficiaries but also harmed the assurance utility of counter-guarantees/counter-standbys for local banks. Under this rule, a beneficiary and a local bank no longer have assurance of quick and certain payment under their respective undertakings in case of non-performance. Contrary to the independence of the independent guarantee/standby from the underlying contract and from the counter-guarantee/counter-standby, according to the *American Express* holding, local bank beneficiary of the counter-guarantee/counter-standby and local beneficiary of the independent guarantee/standby cannot obtain payment until the final resolution of the underlying contact dispute, should such a dispute arise. Moreover, under *American Express* the ability of local bank and beneficiary of the independent guarantee/standby to obtain their respective payment is contingent upon the arbitral panel ruling in the

[170] *See* BERTRAMS, *supra* note 2, at 196; Barru, *supra* note 1, at 80; John F. Dolan, Commentary of Legislative Developments in Letter of Credit Law: An Interim Report, 8 B.F.L.R. 53, 56 (1993).

beneficiary's favor and not canceling beneficiary's independent guarantees/standbys. The rule in *American Express* essentially shifts the burden of going forward with litigation back onto the beneficiary,[171] – precisely the risk that local banks and local beneficiaries seek to avoid when asking for a counter-guarantee/counter-standby and independent guarantee/standby, respectively.[172] The placement of burden of going forward with litigation onto the beneficiary's side is not the arrangement for which Applicant, Beneficiary and Local Bank bargained for when Applicant requested Counter-Guarantor to procure independent guarantees in favor of Beneficiary, and when Local Bank entered into a counter-guarantee/counter-standby agreement with Counter-Guarantor. Ultimately, by generating an additional layer of litigation and administrative costs for banks, and decreasing the predictability and promptness of payment for local banks on their counter-guarantees/counter-standbys and beneficiaries on their independent guarantees/standbys, the *American Express* rule promises to harm the commercial utility of resorting to counter-guarantee and counter-standby arrangements in international project finance.

3. The Sounder Approach to American Express-Type Scenario

The district court could have preserved the integrity of the independence principle by affirming the counter-guarantee rights and obligations of Local Bank and Counter-Guarantor with respect to one another despite the injunction by a court in Spain to prevent the honoring of the counter-guarantees and the contract dispute arbitral award cancelling Beneficiary's independent guarantees. The court should have reached that conclusion absent a showing that but-for the injunction on payment under counter-guarantee/counter-standby, Applicant will suffer "irreparable harm" in the form of having no adequate remedy under law for the alleged material fraud. Admittedly, courts have recognized that proliferation of letter of credit fraud threatens the utility of independent undertakings no less than the erosion of the independence principle.[173] However, a rule that does not neglect to perform the case law-developed injunction analysis before deciding to leave intact an injunction on the use of counter-guarantee/counter-standbys preserves the independence principle's robustness. It does this by preventing the status of the underlying contract to

[171] Stern, *supra* note 8, at 245.

[172] BERTRAMS, *supra* note 2, at 13, 174; Stern, *supra* note 8, at 245.

[173] *See supra* note 15.

affect the rights and obligations under the independent guarantees and standbys, and counter-guarantees/counter-standbys, respectively, in all but the extraordinary cases. At the same time such a rule ensures that letter of credit fraud does not remain unpunished because the rule would require courts to satisfy themselves that the applicant would have a viable opportunity under law to obtain damages for fraud and to recover the amount of the independent guarantees or standbys. As long as the applicant would have adequate legal remedy for the alleged fraud, there is no reason to deviate from adherence to the independence principle at the price of undermining the commercial utility of counter-guarantee/counter-standby arrangements.

Moreover, upholding the counter-guarantee/counter-standby rights and obligations of local bank beneficiaries of counter-guarantee/counter-standbys and the issuers of those undertakings absent a showing of no adequate remedy under law would encourage careful drafting of arbitration agreements so that they help protect the applicant without undermining the independence principle. Such agreements would on the one hand expressly limit the scope of the arbitrators' authority so as to prohibit them from canceling the local independent guarantees/standbys, while on the other hand make the sum of local independent guarantees be recoverable as part of damages should the beneficiary fraudulently draw on its independent guarantees.[174] One key advantage of arbitration over court proceedings is that in light of the wide-spread ratification of the New York Convention, it may be comparatively easier to enforce arbitral awards in signatory countries in which the other party to the dispute has assets.[175] Arbitration agreements could also deter letter of credit fraud by including clauses allowing for award of punitive damages if the case involves conduct that the arbitrators find particularly outrageous.[176]

Conclusion

The district court's holding that until the contract dispute arbitral award canceling Beneficiary's independent guarantees is vacated or modified, neither Beneficiary nor Local Bank has a "colorable right" to demand honor of its independent guarantees and counter-guarantee, respectively, lacks foundation in standard international letter of credit practice, contract law,

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[174] Blodgett and Mayer, *supra* note 169, at 461–62.

[175] Lecuyer-Thieffry & Thieffry, *supra* note 33, at 618.

[176] Blodgett & Mayer, *supra* note 169, at 462.

international public law, New York law, case law-developed standard for issuing injunctions, and policy. First, the independence principle, contract law, Article V-1(c) of the New York Convention, and New York case law do not support the conclusion that an arbitral panel's decision on the underlying contract dispute can alter bank obligations under independent guarantees and counter-guarantees when the outcome of such arbitration is not one of the terms of either undertaking. Second, the court failed to account for the independence of counter-guarantees/counter-standbys from local undertakings: since the only condition for honoring the counter-guarantee was that Local Bank make a bear demand, Local Bank's demand on its counter-guarantee in response to a pending action in Pakistan aimed at forcing Local Bank to pay Beneficiary on its independent guarantees was at least "colorable." Third, contrary to case law-developed standard for issuing injunctions, the district court effectively affirmed an injunction to prevent the honoring of the counter-guarantee and the independent guarantees without first satisfying itself that absent the injunction Applicant would be left out in the cold with no adequate remedy under law against Beneficiary for the amount of the independent guarantees. There is substantial indication that Applicant could have a viable legal remedy here. Third, by failing to treat counter-guarantees/counter-standbys as independent from local undertakings and conditioning the right of local beneficiaries to obtain payment under their independent guarantees/standbys on the outcome of the underlying contract arbitration, the district court's holding hurts the commercial vitality of counter-guarantees/counter-standbys. The court's rule raises the expense of resorting to counter-guarantees/counter-standbys by creating a costly layer of litigation between local banks and local beneficiaries and between local banks and counter-guarantors/issuers of counter-standbys. The court's rule also raises the expense of resorting to counter-guarantee/counter-standby arrangements by forcing local banks to investigate and monitor the underlying contract – the task for which banks are completely ill-suited. Furthermore, the district court's rule decreases the utility of counter-guarantees/counter-standbys and independent guarantees/standbys as security devices by making the prospect of a guaranteed and prompt payment prior to any litigation much less certain. A contrary rule would have been a sounder one. Under such a rule, if the local bank complies with the terms of the counter-guarantee/counter-standby, courts would in general uphold the obligation of a counter-guarantor/issuer of a counter-standby to honor the local bank's demand under its counter-guarantee/counter-standby irrespective of the outcome of the underlying contract dispute arbitration. Derogation from this general rule would only be appropriate in cases where the aggrieved applicant would be left without an adequate remedy under law. On the one hand, this alternative rule would protect the commercial vitality of counter-guarantee/counter-standby arrangements through strict adherence to the independence principle. On the other hand, the rule would assure that letter of credit fraud does not remain unpunished.