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Commercial Law Survey

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I. OVERVIEW

During the survey period, the Tenth Circuit Court of Appeals addressed a variety of issues within the area of commercial law. Economic and political situations, both foreign and domestic, generated engaging issues for appellate review. At home, the mismanagement and failure of banks and savings and loans continued to produce a number of cases for Tenth Circuit review. Part I of this survey will analyze two of these cases: *United States v. Davis*[1] and *Federal Deposit Insurance Corporation v. Canfield*.[2]

In *Davis*, the court decided those who serve a federally insured institution, whether in an employment context or in some other position of trust, are "connected with" that institution for the purpose of conviction for misapplying federally insured funds under 18 U.S.C. § 657.[3] In *Canfield*, a case of first impression at the appellate level, the Tenth Circuit held that the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)[4] provision allowing bank officers and directors to be held personally liable for "gross negligence" does not bar the Federal Deposit Insurance Corporation (FDIC) from seeking recovery against officers and directors under an ordinary negligence theory if applicable state law allows such actions.

Executive Orders issued in response to Iraq's invasion of Kuwait acted as a catalyst for a commercial law case involving letters of credit. Part II of this survey will analyze *Centrifugal Casting Machine Company v. American Bank & Trust*[5] in detail. In *Centrifugal*, the Tenth Circuit examined the complexities of letters of credit, reaching the conclusion that Iraq, as account party to a letter of credit, did not have a property interest in the contract down payment made to a beneficiary, Centrifugal Casting Machine Co. (CCM), even though CCM breached the underlying contract. As a result, the Executive Orders freezing Iraqi assets did not apply to the payment.[6]

1. 953 F.2d 1482 (10th Cir.), *cert. denied*, 112 S. Ct. 2286 (1992).
2. 967 F.2d 443 (10th Cir.), *cert. dismissed*, 113 S. Ct. 516 (1992).
3. 18 U.S.C. § 657 (Supp. III 1991) (it is unlawful for a person who is "an officer, agent or employee of or connected in any capacity with" an insured institution to willfully misapply funds belonging to the institution).
4. In 1989, in response to the large number of bank and savings and loan failures, Congress enacted the FIRREA. FIRREA enables the FDIC to stand in the shoes of the failed bank and its stockholders to sue the officers and directors for mismanagement under state law. Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C.). The issue in the *Canfield* case concerned 12 U.S.C. § 1821(k) (Supp. I 1989).
5. 966 F.2d 1348 (10th Cir. 1992).
6. *Id.* at 1354.

II. Banking Cases

A. *Background*

The savings and loan (S&L) debacle represents one of the greatest scandals in American history. It is generally agreed that directors and officers mismanged the failing S&Ls.[7] Simple incompetence by inexperienced officers and managers combined with fraud resulted in poorly conceived loans and investments, loans to officers and directors, sweetheart loans to affiliated businesses, altered books, bribery and outright embezzlement.[8] Fraud, specifically, is implicated in approximately seventy percent of the failed institutions.[9] The issue before the court in *United States v. Davis*[10] was whether an individual, who was not an officer, director or an agent of a federally insured institution, could be prosecuted for misapplying funds under 18 U.S.C. § 657.[11] Although the Tenth Circuit had not addressed this issue, other circuits have given a broad interpretation of section 657.[12]

In addition to criminal activity, negligent management of financial institutions also contributed to the failure of banks and S&Ls. Although, historically, corporate directors and officers have enjoyed broad discretion in exercising their fiduciary duties,[13] courts increasingly examine

7. Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. S7, S34 (1991).
8. *Id.*
9. *Id.*
10. 953 F.2d 1482 (10th Cir.), *cert. denied*, 112 S. Ct. 2286 (1992).
11. Davis also raised several other unrelated issues on appeal. For a full discussion of these issues see *Davis*, 953 F.2d at 1490-98.
12. In United States v. Prater, 805 F.2d 1441, 1446 (11th Cir. 1986), the president of a real estate subsidiary, solely owned by a savings and loan, was found to be "connected with" the savings and loan under section 657 where the president had the authority to initiate loans and the savings and loan board relied on him for accurate recommendation concerning loans. Those who serve a federally insured institution, whether in an employment context or in some other position of trust, the Eleventh Circuit found, were "connected with" that institution under section 657. *Id. See also* United States v. Payne, 750 F.2d 844, 855 (11th Cir. 1985).

A connection with a federally insured institution may result from control through stock ownership, or control through the power to extend credit. However, such direct control is not necessary to find that a defendant is connected with the institution. United States v. Rice, 645 F.2d 691, 693 (9th Cir.), *cert. denied*, 454 U.S. 862 (1981) (consultant retained by savings and loan to originate loans was "connected with" that institution, notwithstanding that he had not right to approve loans); United States v. Edick, 432 F.2d 350, 352 (4th Cir. 1970) (employee of bank service corporation was connected with the bank). In United States v. Garrett, 396 F.2d 489 (5th Cir.), *cert. denied*, 393 U.S. 952 (1968), controlling stockholders of a bank were charged with misapplication of national bank funds in connection with the purchase of mortgages by the bank. The mortgage sellers paid large commissions to a nonbank corporation owned by the defendants who then distributed the money among themselves. *Id.* at 490. The defendants argued that since they were not officers, directors, agents or employees of the bank, they were outside the reach of the statute. *Id.* The Fifth Circuit disagreed. After examining the connection between the defendants and the bank, the court found that the defendants and their nominees obtained control of the bank by acquiring the majority of its stock. *Id.* at 491. As controlling stockholders, the defendants had a fiduciary duty to both the bank and the minority shareholders. *Id.* The Fifth Circuit concluded the "fact of ownership . . . together with the activity . . . in furtherance of control demonstrates a connection with the bank within the meaning of the statute." *Id.*
13. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988). "Courts interfere seldom to con-

the propriety of corporate decisionmaking.

Financially distraught companies are frequent sources of litigation challenging the actions of corporate directors and officers.[14] With the onslaught of lawsuits, costs of director and officer (D&O) liability insurance increased dramatically.[15] As a result, many directors and officers chose to resign rather than expose themselves to personal liability due to inadequate D&O coverage.[16] Many states quickly responded to these developments by enacting legislation limiting director and officer personal liability.[17] The states limited liability by imposing lower liability standards, some requiring proof of conduct exceeding gross negligence.[18]

Utah, however, takes an opposite position. Under Utah law, an officer or director can be liable for ordinary negligence.[19] The issue before the court in *Canfield* was whether section 1821(k) of FIRREA established a national liability standard of gross negligence for actions brought by the FDIC, and thereby preempted the Utah law that permitted such actions under a simple negligence standard.[20]

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trol such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment." *Id.* (quoting United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917)). Thereafter, the business judgment rule was routinely invoked to validate directors and officers decisions and to insulate them from personal liability. *Id.*

14. *See, e.g.*, Fox v. Chase Manhattan Corp., No. 91 JUV-0831, 1986 WL 637 (Del. Ch. Jan. 2, 1986) (Delaware Chancery Court approved a $32.5 million settlement of suit against Chase Manhattan Corp. and six of its officers arising out of the collapse of Drysdale Government Securities); National Union Fire Ins. Co. v. SeaFirst Corp., 891 F.2d 762 (9th Cir. 1989) (bank holding company and five of its officers agreed to entry of judgment for $10 million).

15. Over the course of one year, D&O insurance increased an astonishing 360%. *Insuring Directors*, WALL ST. J., Mar. 21, 1986, at 31.

16. Hanks, *supra* note 13, at 1209.

17. *See, e.g.*, IND. CODE § 23-1-35-1(e) (1989)(willful misconduct or recklessness); WIS. STAT. § 180.0828(1) (1992)(willful misconduct).

18. *See* sources cited *supra* note 17. *See generally* Hanks, *supra* note 13; Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 3 FORDHAM L. REV. 375 (1988).

19. UTAH CODE ANN. § 16-10a-840 (Supp. 1992).

20. 12 U.S.C. § 1821(k) provides:

> A director or officer of an insured depository institution may be held personally liable for monetary damages in any civilaction by, on behalf of, or at the requestor direction of the Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation-
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> (1) acting as conservator or receiver of such institution,
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> (2) acting based upon a suit, claim, orcause of action purchased for, assigned by, or otherwise conveyed by such receiver or conservator, or
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> (3) acting based upon a suit, claim, or causeof action based upon a suit, claim, orcause of action purchased from, assigned by, or otherwise conveyed in whole or inpart by an insured depository institution or its affiliate in connection withassistance provided under section 1823 of this title, for gross negligence, including similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined underapplicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

12 U.S.C. § 1821(k) (Supp. I 1989).

B. *United States v. Davis*[21]

1. Facts

United States v. Davis involved the theft of federally insured deposits through a series of complex transactions containing elements of deception, collusion, conflicts of interest and self-dealing.[22] Defendants Don C. Davis and Daniel M. Burke misapplied or diverted millions of dollars at the expense of several banks and savings and loans, and ultimately the United States Treasury.[23]

Davis and Burke exercised control over the Guarantee Federal Bank (GFB) as part of a group that controlled a majority block of stock.[24] Burke was a director of GFB, and although Davis was not a board member, he frequently gave financial advice to the board and attended board meetings.[25] Davis and Burke influenced GFB president's decision to purchase securities from bank holding companies in which Davis and Burke had interests.[26] In reality, through a series of transactions, the money was diverted to Davis and Burke. The United States District Court for the District of Wyoming[27] convicted Davis and Burke of misapplying federally insured deposits under 18 U.S.C. § 657.[28] On appeal, Davis argued his conviction was invalid because the prosecution did not meet its burden and establish that Davis was an officer, agent, or employee of a federally insured institution.[29]

2. Tenth Circuit Decision

The Tenth Circuit was unswayed by Davis' argument that only "officers, agents, or employees" who are "connected in any capacity with" an insured institution may be found liable under section 657.[30] The court disagreed with Davis' construction of the statute, finding it too

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21. 953 F.2d 1482 (10th Cir.), *cert. denied*, 112 S. Ct. 2286 (1992).
22. *Id.* at 1486.
23. In addition to being charged with misapplying federally insured funds under 18 U.S.C. § 657, Davis and Burke were also charged with violating 18 U.S.C. § 371 (conspiracy to commit offenses against, and to defraud the United States); 18 U.S.C. § 1343 (wire fraud); 18 U.S.C. § 1006 (making false entries in bank books and records or unlawful receipt of benefits). Davis was also charged with 18 U.S.C. § 1014 (overvaluing security and making false statements). *Davis*, 953 F.2d at 1486.
24. *Davis*, 952 F.2d at 1487.
25. *Id.*
26. *Id.*
27. United States v. Davis Nos. 89-8051, 89-8052, 90-8057, 90-8058 (D. Wyo. 1990) (on file at Denv. U.L. Rev. offices).
28. Davis was convicted on fourteen counts including one count of conspiracy, five counts of wire fraud, four counts of misapplying federally insured funds, two counts of aiding an abetting false entries, one count of aiding and abetting in the unlawful receipt of benefits, and one count of overvaluing securities. The jury convicted Burke on eleven counts including one count of conspiracy, three counts of wire fraud, four counts of misapplying federally insured funds, two counts of make false entries and one count of unlawfully receiving benefits. *Davis*, 952 F.2d at 1486. Burke died soon after sentencing and Davis petitioned the circuit for review. *Id.* at 1487.
29. *Id.* at 1488.
30. 18 U.S.C. § 657 (Supp. III 1991).

narrow.[31] To read the statute as Davis advocated would require the court to ignore the Act's language: "*[w]hoever*, being an officer, agent or employee of or connected in any capacity with."[32] The fact that Davis had not formally been designated an agent of GFB did not preclude the trier of fact from finding an agency relationship based upon conduct.[33] Furthermore, the prosecution did not have to show that Davis was an agent, but merely that he was "connected in any capacity with" an insured financial institution.[34]

The court explained that the "connected in any capacity with" language should be broadly interpreted in accordance with the congressional resolve to protect federally insured institutions against fraud.[35] The court also pointed out that each case should be evaluated on its own facts.[36] Based upon the control Davis exercised over GFB and his extensive participation in the affairs of GFB, the Tenth Circuit concluded that Davis was "connected" with the institution within the meaning of section 657.[37]

C. *Federal Deposit Ins. Corp. v. Canfield*[38]

1. Facts

The Federal Deposit Insurance Corp., brought suit against the former directors and officers of Tracy Collins Bank and Trust, a Utah financial institution, seeking damages of $7 million for imprudent loans made or approved by the defendants, and damages for waste of bank assets and mismanagement.[39] The defendant officers and directors argued that section 1821(k) preempts state law and bars the FDIC from seeking damages from officers and directors for any conduct less than gross negligence.[40] The FDIC asserted that section 1821(k) preserved the ability of the FDIC to sue, when authorized by state law, for damages against officers and directors for ordinary negligence.[41] The FDIC maintained its interpretation was consistent with the objectives of FIRREA. The district court examined the language of section 1821(k), its legislative history and the public policy arguments advanced by both parties, and reached an opposite conclusion, holding that section 1821(k) created a national standard of gross negligence, and thereby preempted conflict-

31. *Id.* at 1489.
32. *Id.* (quoting 18 U.S.C. § 657).
33. *Davis*, 953 F.2d at 1488.
34. *Id.*
35. *Id.* at 1489. *Cf. United States v. Ratchford*, 942 F.2d 702, 705 (10th Cir. 1991), *cert. denied*, 112 S. Ct. 1185 (1992). The Tenth Circuit held that a property manager who diverted funds from an apartment complex owned by two savings and loan associations was sufficiently connected to federally insured institutions to support conviction under § 657.
36. *Davis*, 953 F.2d at 1489.
37. *Id.* at 1989-90.
38. 967 F.2d 443 (10th Cir.) *cert. dismissed*, 113 S. Ct. 516 (1992).
39. *Canfield*, 763 F. Supp. at 534. *See also supra* note 4.
40. *Canfield*, 763 F. Supp. at 534. Under Utah law, the directors and officer would be personally liable for money damage for simple negligence.
41. *Id.*

ing state law.[42]

2. Tenth Circuit Decision

On appeal, the Tenth Circuit mirrored the lower court's analysis of section 1821(k). However, the conclusions were markedly different. Following the district court's analysis, the appellate court began with the plain language of the statute.[43]

According to the Tenth Circuit, the language used in section 1821(k) to describe the potential liability of officers and directors belied the creation of an exclusive national liability standard.[44] The first sentence of the statute states that "a director or officer *may* be held personally liable for monetary damages . . . for gross negligence."[45] The court focused its attention on the word "may", stating that " 'may' is a permissive term, and it does not imply a limitation on the standards of officer and director liability."[46] To affirm the lower court's construction of section 1821(k), the appellate court concluded it would have to construe the first sentence as saying that "an officer or director *may only* be held personally liable for gross negligence."[47] This would require the insertion of a word into the statute, which the court refused to do.[48] Furthermore, the Tenth Circuit found the last sentence of the statute consistent with this interpretation.[49] "Other applicable law", in the last sentence, means all "other applicable law"—state, federal or any other.[50] Any other law providing that an officer or director may be held liable for simple negligence survives, such a law being "other applicable law."[51] Construing the statute to bar application of such "other law" would impair the FDIC's enforcement rights.[52]

In further support of this conclusion, the court relied on the general rule of statutory construction that "the statute should be read as a whole."[53] The court observed that "[n]owhere does the statute announce its intention to create a national standard of liability."[54] In fact, the statute's reliance on state law to define gross negligence contra-

42. *Id.* at 540.
43. Id. at 445. (the Court began with the plain language of the law) (quoting United States v. Morgan, 922 F.2d 1495, 1496 (10th Cir.), *cert. denied*, 111 S.Ct. 2803 (1991)).
44. *Canfield*, 967 F.2d at 446.
45. *Id.* at 446 (quoting 12 U.S.C. § 1821(k)).
46. *Id.* (citing Rose v. Rose, 481 U.S. 619, 626-27 (1987)) (the Court refused to read "may" as establishing anything other than discretionary power).
47. *Canfield*, 967 F.2d at 446.
48. *Id. See* Resolution Trust Corp. v. Lightfoot, 938 F.2d 65, 66-67 (7th Cir. 1991) ("may" does not mean "may only").
49. *Canfield*, 967 F.2d at 446.
50. *Id. See also* Small v. Britton, 500 F.2d 299, 301 (10th Cir. 1974)(reliance must be placed on unambiguous statutes "evident meaning"); Patterson v. Shumate, 112 S. Ct. 2242 (1992)(the Court read "applicable bankruptcy law" in 11 U.S.C. § 541(c)(2) to include both state and federal law).
51. *Canfield*, 967 F.2d at 446.
52. *Id.*
53. *Id.* (citing 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 46.05 (5th ed. 1992)).
54. *Canfield*, 967 F.2d at 447.

dicted the proposition that FIRREA establishes a national standard because state law definitions of gross negligence vary.[55] In contrast, other sections of FIRREA specifically mention the applicability of state law or federal law.[56]

Next, the court reviewed the legislative history behind the statute and found it consistent with its interpretation of the plain meaning of the statute. Specifically, the court followed the senate's lead finding that section 1821 "does not prevent the FDIC from pursuing claims under State law or other applicable Federal law, if such law permits the officers or directors of a financial institution to be sued for violating a lower standard of care, such as simple negligence."[57]

Finally, the Tenth Circuit addressed the public policy arguments raised by the defendants and concluded that these arguments were raised in the wrong forum.[58] By inserting the "other applicable law" verbiage, Congress intended to let the individual states decide the propriety of a simple negligence standard.[59] By doing so, Congress allowed states to consider the implications of problems such as the difficulty of obtaining D&O insurance and its effect on attracting competent and aggressive business leaders.[60] In this case, the court's only consideration was whether the statute prohibited the FDIC from pursuing the Utah action against these defendants; not the merits of a simple negligence standard.[61]

3. Dissenting Opinions

Judges Brorby and Moore file separate dissenting opinions.[62] Brorby's dissent attacked the majority's analysis of legislative intent stating that "[f]ew are so naive as to believe there exists but a single correct interpretation of any given statute."[63] While Brorby believed the majority opinion supportable, he found the better interpretation of section

55. *Id.* "[T]here is . . . no generally accepted meaning [of gross negligence]." *Id.* (W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 34, at 212 (5th ed. 1984).

56. Parts of § 1821 of the statute refer specifically to the other bodies of law it touches. *See, e.g.*, 12 U.S.C. § 1821(c)(3)(B) ("powers imposed by State law"); § 1821(c)(4) ("notwithstanding any other provision of Federal law, the law of any State"). Similarly, when the statute refers to itself, it does so with specificity. *See, e.g.*, § 1821(d)(2)(I) (FDIC may "take any action authorized by this chapter"); § 1821(e)(3)(C)(ii) ("except as otherwise specifically provided in this section"). Additionally, when the statute refers to the whole universe of other laws, it uses the same language as that in section 1821(k). *See also* § 1821(e)(12)(B) ("No provision of this paragraph may be construed as impairing or affecting any right . . . under other applicable law.").

57. *Canfield*, 967 F.2d at 448-49 n.6 (quoting 135 CONG. REC. S6912 (daily ed. June 19, 1989)).

58. *Id.* at 448.

59. *Id.*

60. *Id.* at 448-50. *See supra* note 17 and accompanying text.

61. *Canfield*, 967 F.2d at 448.

62. *Id.* at 449 (Brorby, J., dissenting).

63. *Id.* at 449 n.1. For nearly every canon of statutory construction, there exists an opposing canon which supports a contrary interpretation. *Id.* (citing Karl N. Llewellyn, *Remarks on the Theory of Appellate Decisions and the Rules or Canons About How Statutes are to be Construed*, 3 VAND. L. REV. 395 (1950)).

1821(k) in the district court's opinion which not only gave effect to the plain meaning of the statute, but also served Congress' longstanding goal to achieve uniform administration of federal financial institutions.[64] This interpretation heeds important public policy concerns underlying FIRREA.[65] Therefore, Brorby concluded that section 1821(k) defined "an exclusive, uniform federal threshold of gross negligence for the personal liability of bank directors and officers named in civil damage suits brought by the FDIC."[66]

D. *Analysis of Banking Cases*

The results in *Canfield* and *Davis* are not surprising. The Tenth Circuit decisions in the banking cases show very broad construction and deference to the statutes relating to the mismanagement and failure of banks and savings and loans. It is very clear that the court responded to the public outrage over the saving and loan bailout and its astronomical cost to taxpayers. Although it is too late to correct these past abuses, the court sent a strong message that this type of conduct will not go unchallenged or unpunished. Although the Tenth Circuit opinions in *Canfield* and *Davis* clearly reflect public sentiment, the decisions are well reasoned and supported by a thoughtful analysis of precedent and statutory interpretation doctrine.

The precedential decision in *Canfield* effects officers and directors of financial institutions, placing them on notice that their managerial decisions require considerable deliberation. Challenges to perceived negligent conduct in the management of financial institutions will continue with the courts increasingly willing to scrutinize corporate decisionmaking and award damages when appropriate. It will be interesting to observe the *Canfield* decision's impact on bank and S&L ability to attract competent management. We may see greater hesitation by officers and directors to accept positions in an industry where they are held to a higher decision making standard.

Unlike the *Canfield* opinion, where the Tenth Circuit engaged in independent analysis, the *Davis* decision relied heavily on cases in other circuits to conclude that Davis was "connected" with GFB for the purpose of section 657.[67] In *Davis*, the Tenth Circuit Court primarily relied on a substantially analogous case decided by the Fifth Circuit in *Garrett v. United States*.[68]

The *Davis* opinion, like the *Canfield* opinion, promotes careful scrutiny of bank officials' conduct. *Davis* gives a very broad interpretation of the class of individuals that are "connected with" a federally insured in-

64. *Id.*
65. *Id.* at 451.
66. *Id.* at 452. Judge Moore concurred with Judge Brorby's dissent but wrote separately to emphasize his belief that if Congress had intended to establish a standard of simple negligence for officer and director liability, it would have stated it unequivocally. To conclude otherwise "defies my form of fundamental logic." *Id.* (Moore, J., dissenting).
67. See *supra* note 12.
68. 396 F.2d 489 (5th Cir.), *cert. denied*, 393 U.S. 952 (1968). *See supra* note 12.

stitution for the purpose of criminal responsibility under 18 U.S.C. § 657. Not only will officers, directors and agents of a financial institution be held accountable for misapplying federally insured funds, but those individuals who are less formally and more remotely associated with the federally insured institution are now firmly within the grasp of this statute.

III. Letters of Credit

A. *Background*

The letter of credit was developed as a payment mechanism to alleviate the tension that exists between sellers, who do not want to give up possession of goods before payment is made, and buyers, who want to have control of goods before payment is tendered. In general, the letter of credit transaction is a three party arrangement. An "issuer" (generally a bank) agrees to pay conforming drafts presented under the letter of credit; a bank customer or "account party" orders the letter of credit and dictates its terms; and a "beneficiary" to whom the letter of credit is issued along with the corresponding right to collect monies under the letter of credit by presenting drafts and making proper demand on the issuer.[69] The letter of credit is normally irrevocable[70] and contains an expiration date.

This arrangement results in the beneficiary's assurance of payment because the irrevocable obligation of the account party's bank runs solely to the beneficiary. This obligation requires performance even when a dispute arises between the account party and the beneficiary and the account party requests the issuing bank not to pay.[71] Furthermore, the bank must pay even if the account party is insolvent, cannot, or refuses to reimburse the bank for payment to the beneficiary.[72]

Today two broad categories of letters of credit exist; the "commercial letter of credit" used most commonly in international business transactions to reinforce the mode of payment[73] and the "standby letter of credit" used as a backup against default on obligations.[74] In the past decade, with bank failure, customer failure, beneficiary failure, and the development of standby letters of credit, a considerable volume of litigation over these instruments developed.[75] The defensive positions taken by attorneys, and the poor draftsmanship of letters of credit reflected in these cases illustrate the existing misunderstandings regarding the legal nature of the letters of credit.[76] It is clear that Article 5 of the Uniform

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69. Arbest Const. Co. v. First Nat'l Bank & Trust Co., 777 F.2d 581, 583 (10th Cir. 1985).
70. Uniform Commercial Code § 5-103(1)(a)(B)(1991).
71. *Id.* §§ 5-114(1) to -114(2).
72. *Id.* § 5-114(3).
73. James J. White & Robert S. Summers, Uniform Commercial Code § 19-1, at 806 (3d ed. 1988).
74. *Id.* § 19-1, at 809.
75. *Id.* § 19-2, at 812.
76. *Id.*

Commercial Code, pertaining to letters of credit, is no longer equal to its task.[77] In the case that follows, under the veil of executive orders freezing Iraqi assets in the United States, the Tenth Circuit set out to determine if Iraq, as an account party to a letter of credit, had a property interest in a payment made to a beneficiary who breached the underlying contract.

B. *Centrifugal Casting Machine Co. v. American Bank & Trust Co.*[78]

1. Facts

Iraq was an account party to a letter of credit and a beneficiary of a standby letter of credit.[79] These letters were issued as payment mechanisms in connection with a contract between Centrifugal Casting Machine (CCM), an American company, and State Machinery Trading Company (SMTC), an agency of the Iraqi government.[80]

The parties agreed on an irrevocable letter of credit as the form of payment between SMTC to CCM, for the benefit of CCM in the contact amount.[81] The Central Bank of Iraq (CBI) issued the letter of credit and entitled CCM to draw ten percent of the contract amount as a downpayment ($2.7 million).[82] Additionally, the parties agreed to the issuance of a standby letter of credit in the amount of ten percent of the contract amount ($2.7 million) made by CCM for the benefit of SMTC.[83] This standby letter of credit was available to repay SMTC the amount of the downpayment upon receipt of proof that CCM had not performed under the contract.[84] SMTC attempted to draw on the standby letter of credit, however, the attempt was not accompanied by the requisite proof of CCM's nonperformance. Consequently the drawdown was not honored before the expiration date set out in the letter.[85]

The United States intervened in suits involving parties to the letter of credit and asserted that Iraq had a property interest in $2.7 million deposited by CCM with ABT as security for the standby letter. The United States claimed the bank account containing the $2.7 million was subject to Executive Orders freezing assets of the Iraqi government.[86]

77. *See* JOHN M. STOCKTON & FREDERICK H. MILLER, SALES AND LEASES OF GOODS IN A NUTSHELL 117 (3d ed. 1992); *See also* Task Force Report, *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW. 1521 (1990).

78. 966 F.2d 1348 (10th Cir. 1992).

79. *Id.* at 1349.

80. *Id.*

81. *Id.*

82. *Id.* at 1350.

83. *Id.*

84. This standby letter of credit was issued by Banca Nazionale del Lavoro (BNL) to American Bank of Tulsa (ABT), CCM's bank, as the account party, and made payable to Rafidain Bank, which in turn issued a $2.7 million guarantee to SMTC. *Id.* CCM deposited its downpayment under the letter of credit with ABT as security to protect ABT against any obligation it might incur on the standby letter of credit. *Id.*

85. *Id.*

86. Following Iraq's invasion of Kuwait in August of 1992, President Bush issued two Executive Orders blocking any transfer of property in which Iraq held an interest. *See*

The district court found no valid draw had been made on the standby letter of credit, the letter had expired by its own terms, and that CCM, ABT and BNL had no liability under the standby letter of credit.[87] In doing so, the court rejected the claim of the United States.

2. Tenth Circuit Decision

On appeal, the United States argued that the freeze of Iraqi assets furthered the national policy adopted to punish Iraq by preventing economic benefits from transactions with American citizens and companies.[88] Furthermore, the freeze preserved Iraqi assets for use as bargaining chips in negotiations and sources for compensation for American claims against Iraq.[89] Although the court found the policy arguments compelling, and agreed that Iraqi property interests should be construed in the broadest sense, the court remained unpersuaded that the facts in this case gave rise to a property interest in Iraq when it would not otherwise be cognizable under governing legal principles.[90]

The asset in issue, according to the reasoning of the United States, was the down payment Iraq made on the contract with CCM. Since CCM did not perform on the contract, it was argued that Iraq had an interest in this downpayment based on breach of contract.[91] However, the court disagreed with this reasoning finding it contrary to the principles governing the financial mechanisms chosen by the parties to guarantee payment under the contract.[92]

The Tenth Circuit began its analysis by examining the relationships of the parties under the standby letter of credit.[93] A letter of credit thus involves three legally distinct relationships: "between the issuer and the account party, the issuer and the beneficiary, and the account party and the beneficiary (this last relationship being the underlying business deal

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Exec. Order No. 12,722, 55 Fed. Reg. 31,803 (1990); Exec. Order No. 12,724, 55 Fed. Reg. 33,089 (1990). These orders were implemented by regulations promulgated by the Secretary of the Treasury, through the Office of Foreign Assets Control. See 31 C.F.R. §§ 575.201-.806 (1991). Under these regulations, "no property or interests in property of the Government of Iraq that are in the United States . . . may be transferred, paid, exported, withdrawn or otherwise dealt in." *Id.* § 575.201(a).

87. Centrifugal Casting Machine Co., Inc., v. American Bank & Trust Co., and Iraq, No. 91-5150 (N.D. Okla. 1991) (on file at Denv. U.L. Rev. offices).

88. *Centrifugal*, 966 F.2d at 1350.

89. *Id.* at 1350-51.

90. *Id.* at 1351.

91. *Id.*

92. *Id.*

93. Because the term "letter of credit" was not defined in either the Executive Orders or the implementing regulations, the court used the meaning ordinarily used by the courts and parties dealing with this kind of arrangement. *See* Propper v. Clark, 337 U.S. 472, 480 (1949).

> [A] letter of credit involves three parties: (1) an issuer (generally a bank) who agrees to pay conforming drafts presented under the letter of credit; (2) a bank customer or 'account party' who orders the letter of credit and dictates its terms; and (3) a beneficiary to who the letter of credit is issued, who can collect monies under the letter of credit by presenting drafts and making proper demand on the issuer.

Centrifugal, 966 F.2d at 1351 (quoting Arbest Constr. Co. v. First Nat'l Bank & Trust Co., 777 F.2d 581, 583 (10th Cir. 1985)).

giving rise to the issuance of the letter of credit)."[94] In this case, CBI was the issuer, SMTC was the account party, and CCM was the beneficiary.[95]

The court pointed out two interrelated features of the letter of credit providing its unique value in the marketplace, and are critical to the analysis of the United States claim. First, "[t]he simple result [of a letter of credit] is that the issuer substitutes its credit, preferred by the beneficiary, for that of the account party."[96] The issuing bank pays the beneficiary out of its own funds and then must look to the account party for reimbursement.[97] Second, the issuer's obligation to pay on a letter of credit is entirely independent of the underlying commercial transaction between the beneficiary and the account party.[98] Furthermore, the issuer must honor a proper demand for payment from the beneficiary even if that beneficiary breached the underlying contract.[99] This principal of independence is universally viewed as essential to the proper functioning of a letter of credit and to its particular value, i.e., certainty of payment.[100]

This assurance of payment gives letters of credit a central role in commercial dealings, and gives them a particular value in international transactions, "in which sophisticated investors knowingly undertake such risks as political upheaval or contractual breach in return for the benefits in return for the benefits to be reaped from international trade."[101] Therefore, the courts have concluded that the purpose of the letter of credit would be defeated by examining the merits of the underlying contract dispute to determine whether the letter should be paid.[102]

After analyzing the characteristics of a letter of credit, the court

94. *Centrifugal*, 966 F.2d at 1351.

95. Additionally, BNL was a confirming bank and thus became directly liable to CCM. A "confirming bank" is one which will either itself honor the letter of credit already issued by another bank or guarantees that such a credit will be honored by the issuer or a third bank. *See* OKLA. STAT. tit. 12A, § 5-103(1)(f)(1963). "A confirming bank by confirming a letter of credit becomes directly obligated on the credit to the extent of its confirmation as though it were its issuer and acquires the rights of the issuer." *Id.* § 5-107(2).

96. Arbest Constr. Co. v. First Nat'l Bank & Trust Co., 777 F.2d 581, 583 (10th Cir. 1985). *See also* Republic Nat'l Bank v. Fidelity & Deposit Co., 894 F.2d 1255, 1258 (11th Cir.), *cert. denied*, 111 S. Ct. 308 (1990) (letter of credit gives the beneficiary and irrevocable right to payment, not from the account party, whom might become insolvent or refuse to pay, but from the issuing bank); Airline Reporting Corp. v. First Nat'l Bank, 832 F.2d 823, 826 (4th Cir. 1987) (issuer replaces customer's promise to pay with its own promise to pay); Pringle-Associated Mort. Corp. v. Southern Nat'l Bank, 571 F.2d 871, 874 (5th Cir. 1978) (beneficiary's claim based on letter of credit, not on agreement between issuer and account party and not on the underlying contract).

97. *See generally* Republic Nat'l Bank v. Fidelity & Deposit Co., 894 F.2d 1255, 1257-58 (11th Cir. 1990) (issuer which has honored demand for payment is entitled to immediate repayment).

98. *Centrifugal*, 966 F.2d at 1352. *See also* Ward Petroleum Corp. v. Federal Deposit Ins. Corp., 903 F.2d 1297, 1299-1300 (10th Cir. 1990).

99. *Centrifugal*, 966 F.2d at 1352.

100. *Id. See, e.g.*, Wood v. R.R. Donnelley & Sons Co., 888 F.2d 313 (3d. Cir. 1989); Tradax Petroleum Am., Inc. v. Coral Petroleum, Inc., 878 F.2d 830 (5th Cir. 1989).

101. *Centrifugal*, 966 F.2d at 1352 (quoting Enterprise Int'l, Inc. v. Corporacion Estatal Petrolera Ecuatoriana, 762 F.2d 464, 474 (5th Cir. 1985)).

102. *Id.* at 1353.

concluded that Iraq did not have a property interest in the money CCM received under the letter.[103] The court rejected the contention that Iraq had a property interest in this money as an alleged contract payment made by Iraq, recoverable by Iraq because CCM breached the contract.[104] In doing so, the United States made a breach of contract claim on behalf of Iraq that Iraq never made, created a remedy for the contracting parties in derogation of the remedy they themselves provided[105] and, most importantly, disregarded the controlling legal principles with respect to letters of credit.[106]

In support of the decision, the court emphasized that the payment to CCM under the letter of credit was not made by Iraq, but rather, it was made by the confirming bank, BNL.[107] Furthermore, no legal authority supported the contention that Iraq, as an account party on a letter of credit, had a property interest in the beneficiary's payment based on the beneficiary's alleged breach of the underlying contract.[108] In fact, such a conclusion would be antithetical to the principle of independence that is universally recognized by the courts as crucial to the use of the letter of credit as a financing device.[109] Reliance on the underlying contract is contrary to the unique value of the letter of credit.[110] Payment certainty would be undermined by concluding that the account party had a right to that payment by virtue of the underlying contract prior to litigation on that contract.[111] The beneficiary's bargained for right to retain the payment pending contract litigation would be effectively frustrated.[112]

In conclusion, the court reiterated its recognition that Iraqi assets and property interests should be construed in the broadest sense.[113] However, the court declined to restructure the essential characteristics

103. *Id.*
104. *Id.*
105. The parties themselves provided a remedy through a standby letter of credit in favor of the agent of SMTC, by which SMTC could recover the down payment in the event of a breach by CCM. *Id.* at 1353 n.6. Furthermore, the parties agreed to an expiration date for the standby letter of credit. *Id.* The district court found that this letter expired under its own terms before a proper draw was made upon it. *Id.* The United States did not appeal this ruling. *Id.*
106. *Id.* at 1353.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.* The United States' reliance on Itek Corp. v. First Nat'l Bank, 704 F.2d 1 (1st. Cir. 1983), *aff'd*, 730 F.2d 19 (1984), was not persuasive because that case was factually distinguishable in significant respects. In *Itek*, the First Circuit Court was concerned with essentially identical Executive Orders and regulations with the exception that the assets being frozen were Iran's. Under the letter of credit in that case, Iran was the beneficiary under the letter and thus Iran had a cognizable beneficial interest in the letter. *Id.* at 8. The position of Iran in *Itek* is analogous to Iraq's position as beneficiary of the standby letter of credit in this case. Once again the Tenth Circuit Court emphasized that the United States did not appeal the district court's ruling that any right that Iraq had under the standby letter of credit was extinguished when it expired. *Centrifugal*, 966 F.2d at 1354 n.7.
113. *Centrifugal*, 966 F.2d at 1353.

of a letter of credit in order to create a property interest in the payment made to CCM under the letter of credit.[114] "The national interest is not furthered by creating a property interest out of conditions that would not otherwise generate such an interest, particularly when we must do so at the expense of a critical and unique devise of international trade."[115]

3. Analysis

As stated previously, widespread confusion exists in the legal community concerning the use of letters of credit.[116] Our economy has become more global in nature, and as a result, the use of letters of credit has expanded dramatically in the past decade. Increased use results in a predictable increase in litigation construing letters of credit. As in the *Centrifugal* case, the transactions underlying the use of letters of credit are often very complex, involving numerous international parties and large sums of money.

In *Centrifugal*, the Tenth Circuit perceptively recognized the confusing issues surrounding letters of credit as well as the unique qualities that make them a valuable tool in foreign commerce. Unlike the United States, as intervenor, the Tenth Circuit remained focused on the issues of the case and did not involve itself in patriotic fervor by trying to create an Iraqi interest where one did not exist.

The *Centrifugal* opinion was a successful attempt to shed light and provide understanding of the complexities and desirable characteristics of this payment device. The Tenth Circuit's decision was based on well entrenched law governing letters of credit, providing a simple and understandable analytical framework that practitioners can turn to examine issues raised by the use of letters of credit.

IV. Conclusion

During the 1992 survey period, the Tenth Circuit opinions in *Canfield* and *Davis* continued the court's trend of empowering the FDIC and federal prosecutors by broadly interpreting statutes relating to the failures and abuses in the banking and savings and loan industry. Unlike the *Davis* decision, which was based on established law in other circuits, the *Canfield* opinion is significant in that it is a case of first impression at the appellate level.

The Tenth Circuit based its opinion in *Centrifugal*, like the *Davis* decision, upon established legal doctrine. However, the opinion is notable because it recognizes the widespread confusion surrounding the use of letters of credit as well as the special value of these instruments in inter-

114. *Id.*
115. *Id.* at 1354.
116. *See supra* notes 73-77.

national commerce. The opinion provides a well organized analysis of this financing device and its use.

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