

THE SUPREME COURT OF OHIO'S DECISION IN MID-AMERICA TIRE, INC. V. PTZ TRADING LTD., AND THE WEAKENING OF THE INDEPENDENCE PRINCIPLE

I. INTRODUCTION

The Independence Principle is the foundation of the Letter of Credit transaction.¹ In theory, its primary function is to completely separate an underlying contract for the sale of goods from the contract for payment to the beneficiary.² Because of the Independence Principle, letters of credit have become an integral part of international transactions involving the importing and exporting of goods.³

In its recent holding in *Mid-America Tire, Inc. v. PTZ Trading Ltd.*,⁴ the Ohio Supreme Court was called upon to determine whether an injunction to stop payment on a commercial letter of credit is an appropriate remedy for a claim of fraud existing solely in the underlying sale of goods transaction.⁵ In its 5-2 decision finding that a permanent injunction was proper, the court chose to look behind the letter of credit in contradiction of the independence principle.⁶ This decision to protect an Ohio corporation claiming to be the victim of an underlying fraud as to the quality of goods purchased weakens the credibility of the independence principle by eroding its efficient use in international documentary sales transactions.

This Note will begin with a brief discussion of the basic purpose and function of the letter of credit and its independence principal, followed by an in-depth look at its historic interpretation concerning issues of fraud and the appropriateness of a remedial injunction. The Note will examine both the statutorily-created and judicially-mandated standards of practice and contrast them with *Mid-America Tire's* holding. In addition, this Note will

¹ See Mark S. Blodgett & Donald O. Mayer, *International Letters of Credit: Arbitral Alternatives to Litigating Fraud*, 35 AM. BUS. L.J. 445 (Spring 1998).

² See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 20-1, at 703 (Hornbook Series 4th ed. 1995) (“The most unique and mysterious part of the letter of credit transaction is the independence principle. This principle states that the bank’s obligation to the beneficiary is independent of the beneficiary’s performance on the underlying contract.”).

³ *Id.* at 701.

⁴ 768 N.E.2d 619 (Ohio 2002), *reconsideration denied by* 772 N.E.2d 126 (Ohio 2002).

⁵ *Id.* at 629.

⁶ See *id.* at 639.

address the potentially negative effects this holding will have on future letter of credit jurisprudence. Finally, this Note will explore the numerous protections already embedded in the letter of credit transaction that a buyer has available to prevent a fraud in the underlying contract for the sale of goods.

II. BACKGROUND: THE LETTER OF CREDIT

A. *Basic Policy and Rationale*

The commercial letter of credit is a payment mechanism employed in a sale of goods transaction which “substitutes the payment obligation and creditworthiness of a more solvent party (usually but not necessarily a bank) for the payment obligation . . . of a less solvent party (a buyer, debtor or obligor).”⁷ An important benefit of the letter of credit is that it introduces a third-party payor into the exchange, which eliminates the commercial arm wrestling between the seller who refuses to ship goods until payment is obtained and the buyer who refuses to pay until the goods are received.⁸ Similarly, it is used to prevent the problem of the buyer who uses the excuse of nonconforming goods as a reason not to pay a seller.⁹ The entire transaction, which gives rise to the letter of credit, typically involves three parties and three separate and independent contracts.¹⁰ The initial contract consists of the underlying sale of goods transaction between the buyer and the seller.¹¹ This first contract typically deals with such terms as the quantity and quality of the goods and sets forth the terms for payment and shipment of the goods.¹² One frequently-used provision of this contract will also obligate the buyer to procure a letter of credit from a bank or other issuing third party, who in turn agrees to pay for the goods upon the presentation of the letter by the seller.¹³ This obligation of the buyer to procure the letter compels the creation of the second contract, giving rise to the issuance of the letter of credit.¹⁴

The second contract is comprised of an agreement between the buyer, also called the applicant, and a third party issuer, usually a bank, to issue a

⁷ Gerald T. McLaughlin, *The ABC's of Letters of Credit: Important Financial Instruments*, NAT'L L.J., July 28, 1986, at 40.

⁸ *See id.*

⁹ *See id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.* “[T]he description of the goods on the invoice is critical. . . . This description is important for it is the only assurance that the applicant buyer receives that the goods delivered will be complying.” WHITE & SUMMERS, *supra* note 2, at 706.

¹³ McLaughlin, *supra* note 7, at 40.

¹⁴ WHITE & SUMMERS, *supra* note 2, at 704.

letter of credit in favor of the seller (now called a “beneficiary”).¹⁵ The buyer agrees to reimburse the bank for all payments made on the letter of credit, and, as collateral, the bank usually receives a security interest in the documents of title or goods involved in the underlying transaction.¹⁶ The buyer details the conditions and criteria that are required of the seller for a proper demand for payment to be made upon the issuing bank.¹⁷

The third contract consists of the letter of credit itself. This contract consists of the irrevocable promise from the issuing bank or any intermediary confirming bank to honor a draft or other proper demand for payment presented by a seller/beneficiary with the letter.¹⁸ The proper demand for payment is “documentary in nature” and requires the presentation of “specified shipping documents,” such as a commercial invoice and a bill of lading before the expiration date of the letter of credit.¹⁹ These documents demonstrate that the goods have been shipped according to the underlying contract.²⁰

By definition, the letter of credit guarantees that the bank/issuer will pay upon the letter of credit once a proper demand has been made.²¹ This guarantee is based on a rudimentary function of the letter of credit supported by the “independence principle.” The independence principle derives its name from the theory that the relationships and three contracts between the buyer and seller, the buyer and the issuer, and the issuer and the beneficiary are separate and independent.²² The promise of payment upon proper presentment is absolute irrespective of whether the underlying agreement between the customer and the beneficiary has been satisfied as to all of its terms.²³ The underlying contract for the sale of goods is considered a completely distinct agreement and wholly independent from the contract creating the letter of credit. This is so the issuing bank, in deciding whether payment of the letter is proper, need only concern itself with the document compliance.²⁴ The issuing bank is relieved of any obligation to act as an umpire regarding the conformity of the purchased

¹⁵ McLaughlin, *supra* note 7, at 40.

¹⁶ McLaughlin, *supra* note 7, at 40.

¹⁷ JOHN F. DOLAN, COMMERCIAL LAW ESSENTIAL TERMS AND TRANSACTIONS § 5.3 (2d. ed. 1997).

¹⁸ McLaughlin, *supra* note 7, at 40.

¹⁹ McLaughlin, *supra* note 7, at 40.

²⁰ McLaughlin, *supra* note 7, at 40.

²¹ See BLACK’S LAW DICTIONARY 734 (7th ed. 1999).

²² See *supra* text accompanying notes 8-15.

²³ See BLACK’S LAW DICTIONARY, *supra* note 21, at 734.

²⁴ Michael K. Madden & Carole E. Klinger, *Letters of Credit: When Can Payment Be Prevented or Enjoined?*, MET. CORP. COUNSEL, Greater N.Y. Metro ed., June 1997, at 14.

goods stemming from the underlying sale of goods contract between the buyer and the seller.²⁵

B. *Governing Agreements and Codes*

1. *The Uniform Customs and Practices for Documentary Credits*

The Uniform Customs and Practices for Documentary Credits (UCP) was created as a direct result of the prevalence of letters of credits in international dealings. The UCP, in its purest form, represents a compromise among numerous international industry sectors, articulating current practices in letter of credit transactions.²⁶ Banks located in over 145 nations use the UCP.²⁷ Even though it is not legislative in nature because it is not derived from any particular country's lawmaking body, the UCP is often given the force of law.²⁸ Since the UCP in and of itself is not law, its applicability to a letter of credit transaction must come from incorporation by the parties of the transaction.²⁹ The letter of credit, by its own terms, must explicitly identify the UCP as its guiding principle.³⁰ The UCP is thus considered a "reliable supernational code" whose legitimacy is derived from the voluntary undertaking to a letter of credit by the parties.³¹ The latest edition of the UCP is the 1993 revision, also known as ICC publication No. 500.³² Article 1 of the 1993 UCP enumerates the scope of applicability to both documentary credits and parties to the transaction, as

²⁵ McLaughlin, *supra* note 7, at 40.

²⁶ The International Chamber of Commerce (ICC) published its first incarnation of the UCP in 1933. The UCP's evolution was a direct result of the world banking community's "recognition" of the need for the establishment of consistent procedures harmonizing transactions involving letters of credit. See Isabella Chung, *Developing a Documentary Credit Resolution System: An ICC Perspective*, 19 FORDHAM INT'L L.J. 1349, 1355 (1996).

²⁷ See Blodgett & Mayer, *supra* note 1, at 456.

²⁸ See Chung, *supra* note 26, at 1356. See also Serguei A. Koudriachov, *The Application of the Letter of Credit Form of Payment in International Business Transactions*, 10 CURRENTS INT'L TRADE L.J. 37, 38 (2001) ("In France, the verdict of the Cassational Court (court of appeals) concluded that the UCP has the same normative effect as Articles of the Civil Code."); Official Comment, U.C.C. § 5-101 (2000) ("The Uniform Customs and Practice is an international body of trade practice that is commonly adopted by international and domestic letters of credit and as such is 'law of the transaction' by agreement of the parties.").

²⁹ See Chung, *supra* note 26, at 1357.

³⁰ See Chung, *supra* note 26, at 1357.

³¹ See Chung, *supra* note 26, at 1356-57.

³² U.C.P. § A, art. 1 (1993).

well as the requirement of a textual incorporation into the letter of credit.³³ Once incorporated, the UCP will provide guidance over “such questions as the liabilities and responsibilities of bank issuers, transfer of the credit and the character of the documents presented.”³⁴

The independence principle was not overlooked by the authors of the UCP and is clearly embodied in Articles 3 and 4 of the UCP. Article 3 specifically and unequivocally recognizes the proposition that letters of credit by their nature are separate transactions from the sales or other contracts on which they may be based.³⁵ As if this was not clear enough, the Article further declares that banks are neither “concerned with” nor “bound by” the underlying contracts, regardless of whether there is any “reference whatsoever to such contract[s]” in the letter of credit.³⁶ Thus, the bank’s obligation to pay on a letter made subject to the UCP is not subordinate to any claims or defenses by the buyer emanating from his relationship with the beneficiary. Article 4 further supports the embodiment of the independence principle through its recognition of the importance of “documents, and not with goods, services, and/or other performances to which the documents relate.”³⁷

A significant catalyst of UCP litigation arises from its silence concerning a course of action addressing allegations of fraud. The UCP contains neither a specific provision addressing fraud nor remedies for a potentially wronged buyer.³⁸ There is nothing in the UCP which would permit a buyer to enjoin the bank’s payment on the letter of credit based on the receipt of nonconforming goods. This is largely a result of the magnitude of the independence principle.³⁹ Since the issuing bank is only concerned with the conformity of the documents, as long as a beneficiary presents the required documents, the bank is obligated to pay on the letter of credit. The only reason a bank may refuse payment is if the presented documents are facially inconsistent or nonconforming.⁴⁰ Therefore, under a strict reading of the UCP, where the beneficiary is able to produce documents that are facially consistent and in strict compliance with the

³³ *Id.* (The UCP “shall apply to all Documentary Credits . . . where they are incorporated into the text of the Credit. . . . They are binding on all parties thereto, unless otherwise expressly stipulated in the Credit.”).

³⁴ McLaughlin, *supra* note 7, at 40.

³⁵ U.C.P. § A, art. 3 (1993).

³⁶ *Id.*

³⁷ U.C.P. § A, art. 4 (1993).

³⁸ *See* Blodgett & Mayer, *supra* note 1, at 443-44. “[T]he UCP does not address the issue of enjoining the honor of fraudulent demands; rather, various sections of the UCP emphasize and re-emphasize the centrality of the independence principle.” *Id.* at 456.

³⁹ *Id.*

⁴⁰ U.C.P. § A, art. 13 (1993).

letter of credit requirements, a buyer who alleges a material fraud in the underlying transaction is unable to stop the issuing bank's payment on the letter.⁴¹

2. UCC Article 5 (Revised)

Article 5 of the Uniform Commercial Code (UCC) is another guiding principle in the letter of credit transaction. The goal of Article 5 was two-fold. It was designed to "set a substantive theoretical frame that describes the function and legal nature of letters of credit" and "to preserve procedural flexibility in order to accommodate further development of the efficient use of letters of credit."⁴² Under the UCC, the buyer is referred to as the applicant, the bank is the issuer, and the beneficiary is simply the person entitled to have its complying presentment honored.⁴³ Overall, Article 5 and the UCP are purposefully congruent and strikingly similar in function.⁴⁴ Article 5's treatment of the independence principle is clearly set forth under its scope of application to letters of credit.⁴⁵ Article 5 thus reinforces the isolation of the underlying contract from the actual letter of credit.

The most significant difference between the UCP and Article 5 is the latter's provision addressing fraud and forgery.⁴⁶ Because a wrongful dishonor on the part of the issuer could subject it to incidental damages in addition to the obligation under the letter of credit, it is in the issuer's best interest to pay on the letter absent a court-ordered injunction.⁴⁷ Under Article 5, however, the applicant can be proactive in protecting his liability on the letter of credit by enjoining the bank from issuing payment.⁴⁸ Subject to certain provisions, 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 a temporary or permanent

⁴¹ The buyer, however, is not without recourse and would still be able to seek recovery based on an action for damages arising out of the sale of goods transaction. See McLaughlin, *supra* note 7, at 40.

⁴² See Official Comment, U.C.C. § 5-101 (2000).

⁴³ U.C.C. § 5-102 (2000).

⁴⁴ See Official Comment, U.C.C. § 5-101 (2000) ("Article 5 is consistent with and was influenced by the rules in the existing version of the UCP.").

⁴⁵ See U.C.C. § 5-103(d) (2000) ("Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises.").

⁴⁶ U.C.C. § 5-109 (2000).

⁴⁷ See U.C.C. § 5-111(a) (2000).

⁴⁸ See U.C.C. § 5-109(b) (2000).

injunction on the issuing bank's payment on the letter.⁴⁹ Although the granting of an injunction from payment on a document based upon a claim of forgery is clear, several questions arise as to what constitutes a material fraud in the document and the facilitating of a material fraud in the issuer or applicant.⁵⁰ At the outset, making the material fraud claim is a high hurdle for the applicant to clear.⁵¹ In granting relief, the enjoining court must find that:

- (1) the relief sought is not prohibited under the law applicable to the accepted draft;
- (2) a beneficiary, [or] issuer . . . is adequately protected against [a loss it may suffer if the injunction is granted];
- (3) all requirements under state law have been met;
- (4) the applicant is more likely than not to succeed under its claim of forgery or material fraud.⁵²

C. *Judicial Interpretations and Material Fraud*

Over the past sixty years, the courts have struggled with what constitutes a material fraud as well as when a temporary or permanent injunction on the payment on a letter of credit is proper relief.⁵³ This jurisprudential conflict is derived from the fact that there is potential for fraudulent behavior in either the presentment of documents or in the underlying transaction of a letter of credit.⁵⁴ As previously discussed, banks may dishonor presentment when the fraud involves the letter of credit itself.⁵⁵ Judicial mandate has recognized that courts may enjoin payment in instances where the fraud is in the credit transaction.⁵⁶

Historically, courts have only found the ability to circumvent the independence principle and issue an injunction based on a fraud in the underlying transaction in limited circumstances. As illustrated in *Roman*

⁴⁹ *Id.*

⁵⁰ WHITE & SUMMERS, *supra* note 2.

⁵¹ See Official Comment, U.C.C. § 5-109 (2000) ("The standard for injunctive relief is high, and the burden remains on the applicant to show, by evidence and not by mere allegation, that such relief is warranted.").

⁵² U.C.C. § 5-109(b)(1-4) (2000).

⁵³ See *Mid-America Tire, Inc., v. PTZ Trading Ltd.*, 768 N.E.2d 619, 639-41 (Ohio 2002), *reconsideration denied by* 772 N.E.2d 126 (Ohio 2002).

⁵⁴ See *id.*

⁵⁵ See *supra* 38-50 and accompanying text. See also *Xantech Corp. v. Ramco Industries Inc.*, 643 N.E.2d 918, 920-21 (Ind. Ct. App. 1994).

⁵⁶ See *All Season Industries, Inc. v. Tresfjord Boats*, 563 N.E.2d 174, 177-78 (Ind. Ct. App. 1990).

Ceramics Corp. v. Peoples National Bank,⁵⁷ an injunction has been found to be appropriate relief where the conduct in the presentment of documents was “benefiting ‘an unscrupulous beneficiary’ and that it ‘so vitiate[d] the entire transaction that the legitimate purposes of the independence of . . . the letter of credit . . . are no longer served.’”⁵⁸ In this instance, the “unscrupulous” beneficiary has committed a fraud of such magnitude that the legitimacy of the letter of credit itself is impacted.⁵⁹

Roman Ceramics involved the situation in which Roman, the beneficiary, attempted to deceive a bank by fraudulently making a presentment on a letter of credit.⁶⁰ The letter of credit was issued as a security on an invoice for the sale of goods.⁶¹ The debtor had previously paid the invoice in full, and Roman, through the misallocation of the funds, attempted to induce the bank into paying on the invoice as well.⁶² In granting an injunction for payment on the letter of credit, the court found that Roman had “knowingly and intentionally misallocated the wire payment, with the intention of drawing on the letter of credit so as to be paid twice for the invoices,” and that the “attempted draft constituted fraud in the transaction.”⁶³

The *Roman* court recognized the importance of the independence principle to the legitimacy of the letter of credit and turned its decision in granting the injunction on the nonconformity of the documents presented by Roman.⁶⁴ In particular, the court held, “[i]f the documents submitted have ‘no basis in fact’ and the beneficiary therefore ‘has no bona fide claim to payment under the [underlying contract],’ then the bank may properly be enjoined from honoring, and *a fortiori*, the bank may on its own initiative refuse to honor.”⁶⁵

The *Roman* court relied on two major cases that explore the validity of an injunction based on a claim of fraud in the underlying transaction.⁶⁶ The leading case on point is *Sztejn v. Henry Schroder Banking Corp.*⁶⁷ In *Sztejn*, the plaintiff sought relief from the Supreme Court of New York,

⁵⁷ 714 F.2d 1207 (3d Cir. 1982).

⁵⁸ *Id.* at 1211.

⁵⁹ *Id.*

⁶⁰ *Id.* at 1210.

⁶¹ *Id.* at 1209.

⁶² *Id.* at 1209-10.

⁶³ *Id.* at 1211.

⁶⁴ *Id.* at 1214 (“[I]t must be shown by clear, direct, precise and convincing evidence that the claim of the party attempting to draw on the letter of credit ‘has no basis in fact’, and that this party ‘has no bona fide claim to payment’ at all.”).

⁶⁵ *Id.* at 1212-13.

⁶⁶ *Id.* at 1212.

⁶⁷ 31 N.Y.S. 2d 631 (N.Y. App. Div. 1941).

seeking to enjoin the honoring of a presentment on a letter of credit that was issued to secure payment on the purchase of fifty crates of bristles from an overseas corporation.⁶⁸ Pursuant to the letter of credit, the Indian corporation placed fifty cases of material on a steamship, procured a bill of lading, and obtained the required invoices for a presentment.⁶⁹ The documents described the contents of the crates as bristles, and the Indian corporation attempted to receive payment.⁷⁰ However, the crates did not contain bristles at all, but in fact were filled with “cow hair, other worthless material and rubbish with the intent to simulate genuine merchandise and defraud the plaintiff.”⁷¹

In enjoining the bank’s payment on the letter of credit, the New York court explained that this case was not about the “controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of merchandise.”⁷² The court distinguished the independence principle’s authority to issue payment based on conforming documents from the situation where the bank has knowledge that the documents, although facially conforming to the letter of credit, are in fact fraudulent.⁷³ The documents themselves are, therefore, considered nonconforming, and the bank has the ability to refuse payment due to this nonconformity.⁷⁴

In this instance, the Indian corporation intentionally failed to ship any of the merchandise ordered by the buyer and presented documents that fraudulently declared the goods shipped were those ordered by the plaintiff.⁷⁵ The court held that the independence principle “should not be extended to protect the unscrupulous seller.”⁷⁶

In coming to the conclusion that an injunction was appropriate, the *Sztejn* court was careful to neither undercut the inherent necessity nor downplay the importance of the independence principle.⁷⁷ The court was also mindful of the compelling interest in keeping the bank a neutral party who is unconcerned with the quality and conformity of the goods in the

⁶⁸ *Id.* at 632.

⁶⁹ *Id.* at 633.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 634.

⁷³ *Id.* at 633-34.

⁷⁴ *Id.* “Obviously, when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit.” *Id.* at 635.

⁷⁵ *Id.* at 633.

⁷⁶ *Id.* at 634.

⁷⁷ *See id.* at 634-35.

underlying transaction.⁷⁸ The court further acknowledged the ability of the parties to choose to contract in opposition of the independence principle in order to permit the bank to assume a role of quality control pertaining to the goods in the underlying transaction.⁷⁹ This new relationship assumed by the bank could only come about through a specific provision in the letter of credit.⁸⁰ Absent such a stipulation, the bank will not be required or permitted by the court to delay payments on a properly-presented letter of credit.⁸¹

Courts inspecting allegations of fraud in letters of credit also rely on the Supreme Court of Pennsylvania's decision in *Intraworld Industries, Inc. v. Girard Trust Bank*.⁸² In *Intraworld*, the court denied an injunction on a letter of credit explicitly made subject to the UCP on the grounds that the documents which were presented conformed to the letter of credit requirements, had "some basis in fact," and, therefore, did not constitute a fraud.⁸³ The court also affirmed the general rule requiring the honoring of documents presented in conformity to the requirements stipulated in the letter of credit.⁸⁴

The letter of credit at issue in *Intraworld* was issued as a guarantee of payment on a lease for a hotel.⁸⁵ A lease provision granted the lessor a right to the penalty of one year's lease payments from the nonperformance of the contract on the part of the lessee.⁸⁶ The plaintiff/lessor terminated the lease in September 1973 based on the fact that the defendants failed to pay utility bills, which led to the immanency of mechanics liens being filed on the property—all as a direct result of the defendant's inept operation of the hotel.⁸⁷ In November 1973, the plaintiff presented conforming documents to the issuing bank seeking payment on the letter of credit based on the defendant's nonpayment of rent that had become due.⁸⁸ The

⁷⁸ See *id.* at 633-34. "It would be a most unfortunate interference with business transactions if a bank before honoring drafts upon it was obliged or even allowed to go behind the documents . . . and enter into controversies between the buyer and the seller regarding quality of the merchandise shipped." *Id.* at 633.

⁷⁹ *Id.* at 633.

⁸⁰ See *id.* at 633-34.

⁸¹ *Id.* at 634.

⁸² 336 A.2d 316 (Pa. 1975).

⁸³ *Id.* at 325.

⁸⁴ *Id.* at 323.

⁸⁵ *Id.* at 318-19.

⁸⁶ *Id.* at 319.

⁸⁷ *Id.* at 320.

⁸⁸ *Id.* at 318-22.

defendant sought an injunction claiming the plaintiff's presentment was fraudulent in that the lease was terminated.⁸⁹

In denying the injunction and validating the payment on the letter of credit, the Pennsylvania court held that "[t]he circumstances which will justify an injunction against honor must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served."⁹⁰ Thus, the court found the lessor was entitled to receive payment on the delinquent rent simply because the documents presented were conforming to the requirements under the letter of credit.⁹¹

In a more recent decision, the United States District Court for the Western District of Michigan, Southern Division examined claims of fraud in letter of credit transactions and refused to grant an injunction on payment in *APV Baker, Inc. v. Harris Trust & Savings Bank*.⁹² In *APV Baker*, the plaintiff had entered into a contract with the government of Iran in 1975 for the installation of bakery equipment.⁹³ The Iranian government required AVP Baker's predecessor, Werner Lehara International, to make a good faith performance guarantee through a letter of credit, equaling ten percent of the contract price for the installation of the equipment.⁹⁴ Though suffering many delays, the contract was completed in 1978.⁹⁵ Werner, however, had received neither acceptance from the Iranian Government nor final payment.⁹⁶ The Iranian government made assurances that official acceptance was forthcoming, and Werner extended the expiration date of the letter of credit.⁹⁷

By 1979, the Iranian revolution began to effect relations between the United States and the Iranian government.⁹⁸ President Carter, by 1991, had blocked the transfer of all Iranian assets in the United States.⁹⁹ The regulation required the honoring of any payment demands made by Iran to be placed into blocked accounts established by license through the Treasury Department.¹⁰⁰ Werner obtained such a license and set up the

⁸⁹ *Id.* at 322.

⁹⁰ *Id.* at 324-25,

⁹¹ *Id.*

⁹² 761 F. Supp. 1293 (W.D. Mich. 1991).

⁹³ *Id.* at 1294.

⁹⁴ *Id.*

⁹⁵ *Id.* at 1295.

⁹⁶ *Id.*

⁹⁷ *Id.* at 1295-96.

⁹⁸ *Id.*

⁹⁹ *Id.* at 1296-97.

¹⁰⁰ *Id.*

blocked account in 1981, following a threat by Iran that it would demand payment immediately unless another extension on the letter was granted.¹⁰¹ Werner refused to extend the date any further and the blocked account remained on Werner and APV's books for the next ten years.¹⁰²

In 1991, the United States government revoked the block on the Iranian assets and released the frozen accounts.¹⁰³ Subsequently, APV Baker received notice that the bank intended to pay on the ten-year-old demand that had been made on the letter of credit.¹⁰⁴ APV Baker petitioned the court for an injunction on payment, claiming that the demand for payment was fraudulent and that the expiration date of the letter had long since expired.¹⁰⁵

In denying the injunction, the court determined that the exception for fraud must be narrowly interpreted to give the letter of credit and the UCC their "proper meaning and commercial utility."¹⁰⁶ The court thoroughly examined when the existence of a claim of fraud in the transaction warranted the equitable remedy of an injunction, and agreed with those courts which interpreted fraud in the transaction to exist only in the most "egregious circumstances in which the fraud effectively destroys the original purpose of the independent letter-of-credit transaction."¹⁰⁷ In addition, the court listed the four factors which must be considered by a district court in deciding to grant a preliminary injunction: (1) whether the plaintiff has shown a strong or substantial likelihood of success on the merits; (2) whether the plaintiff has shown irreparable harm; (3) whether issuance of a preliminary injunction would cause substantial harm to others; and (4) whether the public interest would be served by issuing a preliminary injunction.¹⁰⁸

The deciding factor for the court was the plaintiff's failure to show irreparable harm.¹⁰⁹ The court found APV Baker's claim of a lack of an adequate remedy at law to be without merit.¹¹⁰ APV Baker's claim of an inadequate remedy at law was based on the forum selection clause in the letter of credit, which precluded an action against Iranian defendants in

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.* at 1297-98.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 1300-01.

¹⁰⁷ *Id.* at 1300.

¹⁰⁸ *Id.* at 1298.

¹⁰⁹ *Id.* at 1298-99. The court states that while the factors are a guide and there is a need for flexibility, "[a] showing of irreparable harm by the plaintiff is paramount." *Id.* at 1298

¹¹⁰ *Id.* at 1299.

U.S. courts.¹¹¹ As a result of this clause, APV Baker was left to look to the notoriously unfriendly Iranian court system for relief.¹¹² The district court was unsympathetic to APV Baker's contention because the contract was entered into freely and "reduce[d] to some degree the weight to accord this showing of irreparable harm."¹¹³

APV Baker's petition for an injunction was properly denied because its claim of fraud was "limited to the contract" and not in the "independent letter-of-credit."¹¹⁴ The court also acknowledged the scope of international ramifications in granting the injunction based on APV Baker's fraud claim.¹¹⁵ The court found that public interest was best served through the denial of the injunction because "[m]aking an exception to the narrow fraud in the transaction rule could reduce the effectiveness of the standby letter of credit in international commercial transactions," leading to "an erosion in the utility of the device in an international business community."¹¹⁶

III. DISCUSSION AND ANALYSIS

A. *Mid-American Tire v. PTZ Trading Ltd.*

In *Mid -America Tire*, the Supreme Court of Ohio was forced to take a stand on the appropriate relief for a letter of credit transaction, which contained allegations of fraud on the part of the beneficiary.¹¹⁷ Prior to this ruling, the Ohio Supreme Court had not addressed the issues concerning the availability of an injunction for transactions in which a claim of fraud solely in the underlying transaction arises.¹¹⁸ The *Mid-America* transaction was a textbook example of the functionality of the letter of credit. The transaction, funded by an Ohio corporation and secured by a letter of credit, involved numerous parties and middlemen from various countries in

¹¹¹ *Id.*

¹¹² *Id.* at 1298-99.

¹¹³ *Id.* at 1299.

¹¹⁴ *Id.* at 1301.

¹¹⁵ *Id.* at 1302.

¹¹⁶ *Id.*

¹¹⁷ *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, 768 N.E.2d 619 (Ohio 2002), *reconsideration denied* by 772 N.E.2d 126 (Ohio 2002).

¹¹⁸ See *Mid-America Tire Inc. v. PTZ Trading Ltd.*, No. CA99-11-105, 2000 Ohio App. LEXIS 5402, at *18 n.9 (Nov. 20, 2000). "The Ohio Supreme Court expressly declined to address this issue." *Id.* (referring to the court's decision in *State ex rel. Barclays Bank PLC v. Hamilton County Court of Common Pleas*, 660 N.E.2d 458, 540 n.4 (Ohio 1996)).

the attempted purchase and shipment of secondary market snow tires to be sold in the United States.¹¹⁹

1. *The Facts*

In October 1998, Gary Corby, an independent tire broker in the U.K., contacted John Evans, the owner of Transcontinental Tyre Company in England, about obtaining large quantities of Michelin winter tires.¹²⁰ An arrangement was reached through Aloysius Seivers, a German tire broker who would buy tires from Doumerc, a French company authorized to sell overstock Michelin tires worldwide.¹²¹ Seivers would act as an agent of PTZ in procuring the tires, and Evans would sell them on behalf of PTZ to an American purchaser.¹²² At that same time, Corby contacted Paul Chappell, a California-based tire broker, and asked if he had any interest in importing gray market Michelin tires for sale in the U.S.¹²³ Corby explained to Chappell that he had a large client who could offer 50,000 to 70,000 tires per quarter at 40 to 60 percent below the United States market price.¹²⁴ Chappell contacted Fred Jenkins, a Tennessee tire wholesaler and owner of Jenco Marketing Inc., who then contacted Arthur Hine, the President of Mid-America Tire, Inc., an Ohio corporation, who agreed to finance the purchase of the tires.¹²⁵

On October 28, 1998, Corby faxed Chappell a list of available tires, many of which were designated as "DA/2C."¹²⁶ Chappell and Jenkins understood that the DA was a European designation for a defective appearance but were unsure of the 2C designation.¹²⁷ When they asked Corby about the designation, they were told it was used to identify a warehouse location.¹²⁸ Feeling that it was too late in the season to market the winter tires profitably in the U.S., Chappell told Corby that he and Jenkins would be interested in purchasing summer and winter tires and selling them as a package deal.¹²⁹ Corby assured Chappell that summer tires could be obtained at the same discount as the winter tires.¹³⁰

¹¹⁹ See *Mid-America Tire*, 768 N.E.2d at 624.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.* "Gray imports are tires that are imported without the knowledge or approval of a manufacturer into a market that the manufacturer serves, at a greatly reduced price." *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 624-25.

The transaction began to sour over the next few months.¹³¹ Chappel and Jenkins repeatedly asked Corby for a list of the available summer tires, but it was never provided to their satisfaction.¹³² Corby insisted that the list would be forthcoming and the delay was due to the fact that the tires had not been released from Michelin.¹³³ Corby informed Chappel that an agreement regarding the winter tires would have to be reached before the summer tires could be obtained.¹³⁴ Finally in November, Corby faxed a list of available summer tires.¹³⁵ That list, however, did not contain prices and listed several sizes that were unmarketable in the United States.¹³⁶

In December of 1998, Evans faxed a letter and a pro forma invoice setting out the rough terms of the transaction to Jenkins and requested the issuance of a letter of credit for the purchase of the winter tires.¹³⁷ Chappel and Jenkins were hesitant to open the letter of credit without confirmation of the summer tires.¹³⁸ In response, Corby and Evans conditioned the availability of the summer tires on the issuance of the letter of credit in the name of PTZ for the winter tire purchase.¹³⁹ Corby and Evans made it clear that unless a letter of credit was opened, the offer to sell would be withdrawn and there would be no further dealings.¹⁴⁰

Jenkins and Hine opened the letter of credit in January of 1999 as a show of good faith towards the purchase agreement and to obtain the summer tires.¹⁴¹ The letter of credit, effective February 1, 1999 through April 2, 1999, was issued in the amount of \$517,260.33 and was specifically made subject to the Uniform Customs and Practice for Documentary Credits, Publication 500.¹⁴² The letter of credit outlined the various terms and covered the shipment of 14,851 Michelin tires at \$34.83 per tire in accordance with seller's pro forma invoice dated November 19, 1998.¹⁴³

Over the next month, a stalemate erupted in which Corby and Evans insisted on shipping instructions for the tires, and Jenkins and Chappel refused to provide the instructions until a satisfactory list of summer tires

¹³¹ *Id.* at 625.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.* at 625-26

¹³⁵ *Id.* at 625.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.* at 626.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

was produced.¹⁴⁴ Jenkins and Chappel threatened legal action if the tires were shipped without their approval of the summer list.¹⁴⁵ On February 19th, Evans responded with a fax assuring Jenkins that he and Corby were merely trying to obtain the best price for the summer tires from Michelin and were still in negotiations.¹⁴⁶ Further, Evans stated that an ultimatum demanding a specific time for completion would prohibit him from obtaining a competitive price.¹⁴⁷

Finally, on February 23, 1999, Corby faxed Chappel another list of summer tires, which again fell short of Jenkins' expectations.¹⁴⁸ The list consisted of less than the promised 50,000 units, contained many European sizes, and stated some prices exceeding those of competitive U.S. distributors.¹⁴⁹ On March 1, 1999, Jenkins wrote to Evans withdrawing the offer to purchase, stating that the tires were "TOTALLY UNACCEPTABLE" due to the noncompetitive pricing and the inadequate quantity.¹⁵⁰ Shortly thereafter, Chappel and Jenkins discovered that Doumerc, not PTZ, was the company with the Michelin relationship.¹⁵¹ In addition, the tires given the "2C" designation actually meant that the Department of Transportation serial numbers were missing and were illegal for import or sale in the United States.¹⁵² Upon that discovery, Jenkins informed Evans that if the DA/2C tires were shipped, he would notify the United States Customs Service.¹⁵³ Chappel then contacted Doumerc, who agreed not to ship the tires until Chappel and Jenkins had the opportunity to come to France and inspect the tires.¹⁵⁴ On March 11, 1999, Chappel and Jenkins, still hoping to salvage the transaction, attempted to contact Doumerc to inform them that they were willing to extend the letter of credit's expiration date to resolve the situation.¹⁵⁵ Instead of Doumerc, they reached Seivers, who rejected the offer and stated that the tires were his to sell and not Doumerc's.¹⁵⁶ Seivers also informed Chappel and that he intended to ship the tires and present the

¹⁴⁴ *Id.* at 626-27.

¹⁴⁵ *Id.* at 627.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 628.

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

documents for payment.¹⁵⁷ The next day, Mid-America petitioned the court to enjoin payment on the letter of credit.¹⁵⁸ A preliminary injunction was granted on April 8th, and on October 8, 1999, the trial court granted a permanent injunction against the honoring of the letter of credit pursuant to Ohio Revised Code section 1305.08(B).¹⁵⁹

In overturning the injunction granted by the trial court, the Court of Appeals for the Twelfth District of Clermont County, by a 2-1 majority, determined that Mid-America's claim of fraud in the transaction was insufficient to warrant either the granting of equitable relief or the dishonoring of the presented documents.¹⁶⁰ The court of appeals noted that the letter of credit was expressly made subject to the UCP and that those terms replaced those of Ohio Revised Code section 1305.08(B) with respect to whether payment may be enjoined on the basis of fraud.¹⁶¹ The appellate court upheld the independence principle and found that the UCP's silence regarding any fraud exception to the independence principle, by negative inference, necessarily precludes an injunction.¹⁶²

The Supreme Court of Ohio reversed the appellate court and found that the actions of PTZ and its agents constituted a fraud in the underlying transaction warranting injunctive relief.¹⁶³ The court superimposed the Ohio Revised Code over the letter of credit explicitly made subject to the UCP and held that when the "UCP does not contain any rule covering the issue in controversy, the UCP will not replace the relevant provisions of the Ohio Revised Code chapter 1305."¹⁶⁴

2. *The Conflict*

The trial court's determination that the documents presented to the bank for payment strictly complied with the requirements of the letter of credit is a linchpin to this predicament. As previously discussed, nonconforming documents are a prima facie justification for dishonoring a presentment.¹⁶⁵ Had this been a simple case of an unscrupulous seller

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, No. CA99-11-105, 2000 Ohio App. LEXIS 5402, at *50 (Nov. 20, 2000).

¹⁶¹ *See id.*

¹⁶² *See id.*

¹⁶³ *Mid-America Tire, Inc., v. PTZ Trading Ltd.*, 768 N.E.2d 619, 640-41 (Ohio 2002), *reconsideration denied by* 772 N.E.2d 126 (Ohio 2002).

¹⁶⁴ *Id.* at 636-37.

¹⁶⁵ *See supra* notes 38-50 and accompanying text. "The cases and Revised Article 5 are more forthcoming. Section 5-108 explicitly calls for strict compliance of the presentation with the letter of credit. Cases holding that a beneficiary's 'reasonable' or

(continued)

using forged documents in an attempt to bilk a naive buyer, an injunction clearly would have been the proper course of action. According to the appellate court, there cannot be an injunction based purely on the claim of fraud in the underlying contract.¹⁶⁶ There must also be proof of a perpetuated fraud in the letter of credit at issue.¹⁶⁷

The appellate court began its analysis of the lower court's decision by reviewing the purpose of the letter of credit and the independence principle.¹⁶⁸ The court noted that UCC Article 5 is codified in Ohio by Ohio Revised Code chapter 1305, and specifically, Ohio Revised Code section 1305.02(D) has adopted the "independence principle."¹⁶⁹ Therefore, the history of the "independence principle" and its strong foothold in Ohio was clear.¹⁷⁰

A major fault the appellate court found with the granting of the injunction was the fact that the alleged fraud did not qualify as an exception to the independence principle.¹⁷¹ The court analyzed this issue according to the authority of *APV Baker, Roman Ceramics, Intraworld*, and *Sztejn*.¹⁷² The court believed the alleged fraud on the part of PTZ was insufficient to warrant an injunction.¹⁷³ "In such a case, the beneficiary not only commits a fraud in the underlying contract, but the beneficiary carries that fraud so far as to impact the L/C itself."¹⁷⁴ The appellate court reasoned that since the documents presented by Seivers were in strict

'substantial' compliance will do are a small minority." *WHITE & SUMMERS, supra* note 2, at 701.

¹⁶⁶ *Mid-America Tire, Inc. v. PTZ Trading, Ltd.*, No. CA99-11-105, 2000 Ohio App. LEXIS 5402, at *51 (Nov. 20, 2000).

¹⁶⁷ *Id.*

¹⁶⁸ *See id.* at *11-13. "A L/C functions as a separate transaction from the underlying contract, being comprised of a set of obligations different from those making up the underlying contract." *Id.* at *12. "The L/C's separation from the underlying contract is referred to as the 'independence principle.'" *Id.* at *13.

¹⁶⁹ *Id.* at *14 n.3 & 5. *See also Mantua Mfg. Co. v. Commerce Exch. Bank*, 661 N.E.2d 161 (Ohio 1996).

¹⁷⁰ The Supreme Court of Ohio addressed issues concerning letters of credit and discussed the importance of the independence principle in two recent cases: *Mantua Mfg. Co.*, 661 N.E.2d 161 (Ohio 1996), and *State ex rel. Barclays Bank PLC v. Hamilton County Court of Common Pleas*, 660 N.E.2d 458 (Ohio 1996).

¹⁷¹ *See Mid-America Tire, Inc.*, 2000 Ohio App. LEXIS 5402, at *50.

¹⁷² *Id.* at *29-41. *See discussion infra* Part II.C.

¹⁷³ *Id.*

¹⁷⁴ *Id.* at *31. *See also Roman Ceramics Corp. v. Peoples Nat'l Bank*, 714 F.2d 1207 (3d Cir. 1983).

compliance with the letter of credit requirements, the entire transaction was not vitiated and the letter of credit should have been honored.¹⁷⁵

Another issue the appellate court found troubling concerning the trial court's holding was the fact that Mid-America Tire and Jenkins fell short of meeting all of the requirements provided under section 1305.05(B)(3) to substantiate an injunction.¹⁷⁶ In particular, there was still an adequate remedy at law based upon the fraud in the underlying contract from which damages could be recovered even if the letter of credit was honored.¹⁷⁷ Any damages incurred would be purely monetary in nature and therefore could be rectified without resorting to an equitable action.¹⁷⁸

In its analysis reversing the lower court, the Ohio Supreme Court chose to look behind the letter of credit and considered the situation according to the sale of goods transaction.¹⁷⁹ Upon its reconsideration of the facts in *Mid America Tire*, the Supreme Court of Ohio criticized the appellate court's decision to overrule the injunction as construing the "vitiation exception" so narrowly as to preclude relief where the beneficiary's fraudulent conduct occurs solely in the underlying transaction.¹⁸⁰ Interestingly enough, the Supreme Court of Ohio reinstated the injunction based on the same case authority cited by the appellate court in invalidating it.¹⁸¹ The court's analysis of the "seminal" case of *Sztejn* and its progeny led it to conclude that a "material fraud committed by the beneficiary in either the letter of credit transaction or the underlying sales transaction is sufficient to warrant injunctive relief under R.C. 1305.08(B)."¹⁸² Further, in addressing the appropriate measure of fraud, the court favored the holding in *Itek Corp. v. First National Bank of Boston*,¹⁸³ and found that section 1305.08(B) refers to a material fraud as one that "[s]o vitiate[s] the entire transaction that the legitimate purposes of the independence of the issuer's obligation can no longer be served."¹⁸⁴

¹⁷⁵ *Mid-America Tire*, 2000 Ohio App. LEXIS 5402, at *48.

¹⁷⁶ *Id.* at *49 ("For an injunction to issue under R.C. 1305.08(B), a party must demonstrate that 'all conditions to entitle a person to the relief under the law of this state have been met.'").

¹⁷⁷ *Id.* at *48.

¹⁷⁸ *Id.*

¹⁷⁹ See *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, 768 N.E.2d 619, 640 (Ohio 2002), *reconsideration denied by* 772 N.E.2d 126 (Ohio 2002).

¹⁸⁰ *Id.*

¹⁸¹ *Id.* ("Thus, the court of appeals relied on the right cases for the wrong reasons.").

¹⁸² *Id.* at 639. See *supra* notes 67-81 and accompanying text.

¹⁸³ 730 F.2d 19 (1st Cir. 1984).

¹⁸⁴ *Mid-America Tire*, 768 N.E.2d at 640 (quoting *Itek*, 730 F.2d at 25).

The Ohio Supreme Court also found fault in the appellate court's determination that Mid-America Tire had an adequate remedy at law based upon the underlying contract.¹⁸⁵ According to the Ohio Supreme Court's analysis, an equitable remedy is appropriate when the suit for damages on the underlying contract would not be as quick or as practical as the equitable action.¹⁸⁶ The court's reasoning is founded upon the difficulty the plaintiffs would have in determining marketability of the tires both in the United States and overseas.¹⁸⁷ According to the court, this burdensome fixing of price is sufficient to make any possible remedy at law completely inadequate.¹⁸⁸

B. Analysis: Why Granting the Injunction Was Inappropriate

1. Conflicting Ohio Law

As stated above, Ohio has adopted UCC Article 5 through Ohio Revised Code Chapter 1305.¹⁸⁹ Section 1305.08 is the codification of UCC section 5-109's Fraud and Forgery provision.¹⁹⁰ Under section 1305.08(B), a party seeking an injunction based on a claim that the document is forged or fraudulent or because honoring the document facilitated a material fraud must meet the four explicitly-enumerated conditions.¹⁹¹ The third requirement is perhaps the most relevant to the case at issue. It mandates that a party seeking an injunction must show that "[a]ll of the conditions that entitle a person to the relief under the law of this state have been met."¹⁹² Ohio law has determined that a person seeking an injunction must first show that there is not an adequate remedy at law available and that they will suffer irreparable harm.¹⁹³ Therefore, under Ohio law, the *Mid-America Tire* injunction should have been denied from the outset of the controversy. The damages suffered by the plaintiffs in *Mid-America Tire* were purely monetary in nature and were able to be

¹⁸⁵ According to the Ohio Supreme Court, the appellate court should not have even considered this issue. *See id.* PTZ did not raise the available adequate remedy at law claim until its appeal and therefore effectively waived this issue.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *See supra* text accompanying note 169.

¹⁹⁰ *See supra* text accompanying note 169.

¹⁹¹ OHIO REV. CODE ANN. § 1305.08(B) (Anderson 2002). *See supra* notes 51-52 and accompanying text.

¹⁹² OHIO REV. CODE ANN. § 1305.08(B)(3).

¹⁹³ *Mid-America Tire, Inc. v. PTZ Trading, Ltd.*, No. CA99-11-105, 2000 Ohio App. LEXIS 5402, at *40 n.17 (Nov. 20, 2000) (citing *Haig v. Ohio State Bd. of Educ.*, 584 N.E.2d 704, 707 (Ohio 1992)).

remedied outside of an equitable court action.¹⁹⁴ Mid-America Tire and Jenkins would have the opportunity to seek damages at law, resulting from the alleged fraud in the underlying contract, even if the letter of credit had been honored.¹⁹⁵ The fact that Mid-America Tire and Jenkins would have to pursue damages in an unfriendly foreign court system, by itself, was insufficient to warrant the granting of an injunction.¹⁹⁶

The Ohio Revised Code, like the UCC, permits parties in a letter of credit transaction to vary both the terms of the letter of credit and to choose the applicable law to which they will be bound.¹⁹⁷ Should a conflict between the chosen law and the Revised Code come about, the Revised Code, by its very terms, presumes the validity of the intentions of the contracting parties and subordinates itself to the chosen law.¹⁹⁸ In other words, if the parties to a transaction choose the UCP to govern the letter of credit, the Revised Code should become subordinate. This was precisely the stand taken by the appellate court in presiding over the *Mid-America* facts and overturning the injunction.¹⁹⁹ In procuring the letter of credit, Jenkins and Chappell voluntarily chose the UCP as the governing principle.²⁰⁰ The appellate court's decision to deny the injunction maintained the integrity of the independence principle and upheld the right of a buyer and seller to contract outside of the UCC.

2. *Conflicting with the UCC*

The Ohio Supreme Court's classification of the Mid-America transaction as a material fraud is inconsistent with the commentary to the UCC. In drafting the latest revision to UCC Article 5, which became effective in Ohio on July 1, 1998, the authors were mindful of the prior

¹⁹⁴ *Mid-America Tire*, 2000 Ohio App. LEXIS 5402, at *48. The testimony of Jenkins and Chappell at trial revealed that they had made arrangements to sell the tires once payment on the letter of credit had occurred. *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Mid-America Tire, Inc., v. PTZ Trading Ltd.*, 768 N.E.2d 619, 631 (Ohio 2002), *reconsideration denied* by 772 N.E.2d 126 (Ohio 2002).

¹⁹⁷ OHIO REV. CODE ANN. § 1305.15(A) (Anderson 2002).

¹⁹⁸ OHIO REV. CODE ANN. § 1305.15(C) (“[T]he liability of an issuer, nominated person, or adviser is governed by any rules of custom or practice, such as the uniform customs and practice for documentary credits, to which [a] letter of credit . . . is expressly made subject.”).

¹⁹⁹ *Mid-America Tire*, 2000 Ohio App. LEXIS 5402, at *20.

²⁰⁰ *Id.* at *25.

judicial interpretations of former UCC section 5-114.²⁰¹ Under former UCC section 5-114(2)(b), an injunction was an appropriate remedy under the partially-ambiguous circumstances in which a required document “is forged or fraudulent or there is fraud in the transaction.”²⁰² It was the subsequent case law that drew the lines as to what “fraud in the transaction” really meant and gave rise to the term material in relation to letter of credit law.²⁰³

The Official Comment to UCC section 5-109, the most recent fraud provision, provides that a “[m]aterial fraud by the beneficiary occurs only when the beneficiary has no colorable right to expect honor and where there is no basis in fact to support such a right to honor.”²⁰⁴ A close examination of the Official Comment to UCC section 5-109 offers insight as to when the issuance of an injunction from the honoring of a letter of credit is proper.²⁰⁵ According to the Official Comment, the recodification “makes [it] clear that fraud must be found either in the documents or must have been committed by the beneficiary on the issuer or the applicant.”²⁰⁶ Further, the recodification stresses that UCC section 5-109 mandates the alleged fraud to be material.²⁰⁷ In relevant part, UCC section 5-109(b) provides:

If an applicant claims that a required document is forged or materially fraudulent or that the 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 persons²⁰⁸

The importance of the adjective “material” in accentuating the fraud is directly correlated to the recognized importance of the independence principle.²⁰⁹

²⁰¹ See UCC § 5-109, cmt. 1 (2000) (“The section indorses articulations such as those stated in *Intraworld . . . Roman Ceramics . . .* and similar decisions and embraces certain decisions under Section 5-114 that relied upon the phrase ‘fraud in the transaction.’”).

²⁰² U.C.C. § 5-114(2)(b) (1992).

²⁰³ See *infra* notes 53-116 and accompanying text.

²⁰⁴ U.C.C. § 5-109, cmt. 1.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ U.C.C. § 5-109(b).

²⁰⁸ U.C.C. § 5-109(b).

²⁰⁹ U.C.C. § 5-109, cmt. 5 (“Courts should not allow the ‘sacred cow of equity to trample the tender vines of letter of credit law’”).

In an attempt to clarify the required interpretation of a material fraud, UCC section 5-109's commentary offers a hypothetical involving the delivery of one thousand barrels of salad oil.²¹⁰ This hypothetical undeniably relates the alleged fraud in the performance of the underlying transaction to the conformity of the documents presented for payment as required by the letter of credit.²¹¹ Referring to a transaction in which a beneficiary contracts to ship 1000 barrels but only delivers five barrels, the official commentary provides: "[T]he knowing submission of those invoices . . . would be materially fraudulent."²¹² This hypothetical is congruent with the shipping of boxes of trash when the buyer purchased bristles.²¹³ Like the *Sztejn* holding, the fact that only two of the required 1000 barrels were delivered would rise to the level of a fraud in the letter of credit transaction. The presented documents that claim all barrels have been delivered are fraudulent and an injunction would be proper.²¹⁴ However, if that same beneficiary ships all but two of the barrels purchased by the issuer of the letter of credit, the beneficiary's actions would not be "materially fraudulent" and an injunction should be denied.²¹⁵

Comparing the Official Comment's hypothetical to the fact pattern in *Mid-America Tire*, it becomes apparent that there was not a properly-enjoinable material fraud perpetuated by either PTZ or its agents. In *Mid-America Tire*, the beneficiary, PTZ, had contracted to sell 14,851 gray market tires below the United States market price.²¹⁶ The terms of the letter of credit only required for there to be a proper presentment of the pro forma invoice dated November 19, 1998.²¹⁷ The pro forma invoice, by definition, only stated the quantity to be shipped and the price to be paid.²¹⁸ Jenkins and Chappell, in procuring the letter, did not include a provision detailing the styles of tires to be shipped or require anything other than a presentment that was facially compliant with the pro forma invoice.²¹⁹

²¹⁰ U.C.C. § 5-109, cmt. 1.

²¹¹ *Id.*

²¹² *Id.*

²¹³ See *supra* notes 67-71 and accompanying text.

²¹⁴ See *Sztejn v. Henry Schroder Banking Corp.*, 31 N.Y.S. 2d 631 (N.Y. App. Div. 1941).

²¹⁵ U.C.C. § 5-109, cmt. 1 ("[T]hough possibly fraudulent, [the act] is not materially so and would not justify an injunction.")

²¹⁶ *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, 768 N.E.2d 619, 627 (Ohio 2002), *reconsideration denied* by 772 N.E.2d 126 (Ohio 2002) (explaining that "'Grey Imports' are tires that are imported without the knowledge or approval of a manufacturer into a market that the manufacturer serves, at a greatly reduced price.").

²¹⁷ *Id.*

²¹⁸ *Id.* at 626.

²¹⁹ *Id.*

Thus, PTZ, in shipping 14,851 snow tires, sent a quantity of tires that was identical to the number listed on the pro forma invoice in strict compliance with the provisions set forth by the buyers.²²⁰ Furthermore, the winter tires shipped were the same styles originally offered to Jenkins and Chappell at the outset of the transaction and when they opened the letter of credit.²²¹

3. *Conflicting with Prior Precedent*

Comparing the transaction in *Mid-America Tire* to the facts of similar cases in which an injunction was proper also leads to the conclusion that the injunction upheld by the Ohio Supreme Court was inappropriate. These cases seem to suggest that a fraud substantial enough to warrant equitable relief must be extraordinary. The allegations of fraud in the *Mid-America* transaction simply do not rise to the same level of fraud as shipping garbage instead of brush bristles.²²² It is not equivalent to the intentional transport of old, tattered, and mildewed boxing gloves instead of newly manufactured gloves.²²³ The transaction in *Mid-America Tire* was initiated as an offer to sell winter tires at a reduced rate.²²⁴ Jenkins and Chappell opened the letter of credit specifically for the purchase of winter tires.²²⁵

Ultimately the tires shipped by agents of PTZ were identical to the ones originally bargained for and bearing the "DA/C2" designation.²²⁶ It is undisputed that that the presentment made was in compliance with the requirements of the letter of credit.²²⁷

There is no doubt that the actions of PTZ and its agents in failing to disclose that some of the tires were missing the Department of Transportation serial number and then shipping the tires despite a request not to constitute bad faith practices. These deceitful actions, however, are not as unscrupulous as a beneficiary who purposefully misrepresents paid invoices in order to bilk a buyer and receive double payment on a letter of credit.²²⁸ Jenkins and Chappell, as experienced entrepreneurs in the business of buying and selling tires, had all of the information in front of them to make an informed decision as to whether to proceed with the

²²⁰ *Id.* at 626-28.

²²¹ *Id.* at 629.

²²² *See* *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (N.Y. App. Div. 1941).

²²³ *See* *United Bank Ltd. v. Cambridge Sporting Goods Corp.*, 360 N.E.2d 943 (N.Y. 1976).

²²⁴ *Mid-America Tire*, 768 N.E.2d at 624.

²²⁵ *Id.* at 626.

²²⁶ *See id.* at 629.

²²⁷ *See id.*

²²⁸ *See* *Roman Ceramics Corp. v. Peoples Nat'l Bank*, 714 F.2d 1207 (3d Cir. 1982).

transaction.²²⁹ Had PTZ withheld the tire designation altogether or shipped something other than tires, an injunction would have been warranted. In those instances, the facts would have been more in line with *Sztejn* and its progeny.²³⁰

IV. SIGNIFICANCE

A. *The Application to Future Ohio Letter of Credit Jurisprudence*

The significance of the Ohio Supreme Court's holding in *Mid-America Tire* lies in the weakening of the independence principle. Under *Mid-America Tire*, the letter of credit becomes intertwined with the contract for the sale of goods on which the letter was procured. Beneficiaries of transactions involving letters of credit in Ohio must now concern themselves with the buyer's perception of the underlying transaction.²³¹ *Mid-America Tire* potentially creates the beginning of a slippery slope for judges to ascend in deciphering when an injunction is truly appropriate in claims of fraud. The more receptive the American court system becomes to impeding the independence of the letter of credit, the greater the possibility "that American letters of credit will be shunned abroad, or less widely accepted, with attendant losses to American issuing banks."²³²

B. *Avoiding the "Mid-America Predicament": What an Attorney Can Do to Protect the Client*

The letter of credit transaction contains inherent protections, which all but eliminate those situations that could potentially create opportunities for fraud. The buyer is in the best position to prevent opportunities of fraud to be perpetuated by the seller of the goods and must avail himself of the available protections.²³³ Unfortunately, the greater the protection sought, the greater the expense the buyer incurs. The buyer of the goods mandates the terms and types of documents which the beneficiary or seller must produce to make a proper presentment and receive payment.²³⁴ Typically,

²²⁹ See discussion *supra* Part III.A.

²³⁰ See discussion *supra* Part II.C.

²³¹ See Blodgett & Mayer, *supra* note 1, at 443. "For example, an account party could dishonestly raise allegations of fraud simply to delay payment to a seller/beneficiary, or could honestly believe that a serious breach of warranty represented a case of fraud." *Id.* at 452.

²³² *Id.* at 445 (quoting Memorandum from James J. White to the Drafting Committee of Revised U.C.C. Art. 5).

²³³ DOLAN, *supra* note 17, at § 5.3.

²³⁴ DOLAN, *supra* note 17, at § 5.3. "Unless the credit is 'clean,' that is, a credit that calls only for the beneficiary's draft, the credit will contain rather explicit terms relating to
(continued)

these requirements and terms will include a detailed description of the goods, amount of the credit, a bill of lading, performance bonds, last date shipping is permitted, availability of partial shipments, destination instructions, and whether inspection certificates and insurance is required.²³⁵

1. *The Bill of Lading*

The bill of lading is a certificate issued by a carrier that states that goods have been received for shipment.²³⁶ Once the goods are actually loaded onto a vessel, the carrier or its agent will then affix a signed and dated “on board stamp” to the bill.²³⁷ The absence of an “on board stamp” on a bill of lading will indicate a red flag to the buyer and the paying bank that there is something wrong and payment should be withheld.²³⁸ The bill of lading itself, however, is not enough to assure the buyer that the goods being shipped are identical to those that were contracted for. It is only a statement indicating that “some type of goods” have been received by the carrier for transport.²³⁹ Since the bill of lading is not a guarantee by the carrier to the buyer that the goods placed on the vessel precisely match the goods that were contracted for, a prudent buyer should require even more protection.²⁴⁰

2. *Inspection Certificates*

An inspection certificate is one of the most effective ways for a buyer to alleviate any misgivings or doubts concerning the seller’s honesty.²⁴¹ As the name suggests, the inspection certificate is issued by what is typically a third party agency who examines the goods once received by the carrier and before transport to the buyer.²⁴² The inspection, in most cases done at

the documents that the paying bank must have before it will honor the beneficiary’s draft.” DOLAN, *supra* note 17, at § 5.4.

²³⁵ DOLAN, *supra* note 17, at § 5.3. Sometimes such terms will be incorporated into the transaction implicitly through either industry customs and practices, or by the parties’ prior course of dealing. DOLAN, *supra* note 17, at § 5.3.

²³⁶ DOLAN, *supra* note 17, at § 5.4.

²³⁷ DOLAN, *supra* note 17, at § 5.4.

²³⁸ DOLAN, *supra* note 17, at § 5.4. “For the on board stamp to be missing would signal danger, since most insurance coverage does not commence until the goods are loaded on board. DOLAN, *supra* note 17, at § 5.4.

²³⁹ DOLAN, *supra* note 17, at § 5.4.

²⁴⁰ DOLAN, *supra* note 17, at § 5.4. “Generally, the bill of lading contains disclaimer language that the law generally, though not without exception, respects.” DOLAN, *supra* note 17, at § 5.4.

²⁴¹ DOLAN, *supra* note 17, at § 5.4.

²⁴² DOLAN, *supra* note 17, at § 5.4.

the buyer's expense, should be detailed in the letter of credit and required in order for the seller to achieve a proper presentment of documents.²⁴³ The inspection certificate should identify the agency performing the inspection as well as indicate exactly how and what the inspectors should be identifying.²⁴⁴ If the letter of credit is silent regarding the details of the inspection certificate, the protection the certificate provides is undercut and its entire purpose is defeated.²⁴⁵ The issuing bank in fulfilling its duty to examine the compliance of documents would only be required to accept a signed certificate.²⁴⁶ Theoretically, the seller could then sign the certificate and it would be valid.²⁴⁷

Mid-America Tire and Jenco should have required an inspection certificate by a neutral third party. The certificate should have described the styles, sizes, and types of tires to be transported. This inspection would have insured that the tires would have complied with the letter of credit or else would not be shippable.

3. Commercial Invoices

The parties in the *Mid-America Tire* transaction were not ignorant and inexperienced in the ways of business and tire importing.²⁴⁸ The buyers were in control of the amount of protection they wished to afford themselves. Their biggest mistake was to open the letter of credit in which a pro forma invoice was required for presentment.²⁴⁹ Jenco and Mid-America Tire should have required a commercial invoice containing specific and detailed descriptions of the tires they were purchasing.²⁵⁰ If the descriptions of the tires on PTZ's commercial invoice were not identical to the description mandated by the letter of credit, the paying bank would have no choice but to dishonor the presentment.²⁵¹

²⁴³ DOLAN, *supra* note 17, at §§ 5.3-5.4.

²⁴⁴ DOLAN, *supra* note 17, at § 5.4.

²⁴⁵ DOLAN, *supra* note 17, at § 5.4.

²⁴⁶ DOLAN, *supra* note 17, at § 5.4.

²⁴⁷ DOLAN, *supra* note 17, at § 5.4.

²⁴⁸ See *Mid-America Tire, Inc. v. PTZ Trading Ltd.*, 768 N.E.2d 619, 623 (Ohio 2002), *reconsideration denied by* 772 N.E.2d 126 (Ohio 2002) (indicating that all of the parties involved were engaged in the business of tire importing and exporting).

²⁴⁹ See *supra* text accompanying notes 138-143.

²⁵⁰ DOLAN, *supra* note 17, at § 5.4 ("Traditionally, letter-of-credit law puts great store by the description of the goods in the invoice and requires that description to track the description of the goods in the letter of credit.").

²⁵¹ In the event the invoice descriptions do not conform to those of the letter of credit, the bank will notify the buyer who may choose to waive the discrepancies. DOLAN, *supra* note 17, at § 5.4. If the buyer does not waive, the seller will have the opportunity to comply until the letter of credit expires. DOLAN, *supra* note 17, at § 5.4.

4. *Countersigned Documents*

If Jenco and Mid-America wanted ultimate protection, they could have required a countersigned document to be presented for payment. A countersigned document would require the signature of “some party” who grants final approval of the transaction and the invoice prior to the issuance of payment.²⁵² Without this signature, the seller is unable to fulfill the explicit terms of the letter of credit and would be unable to receive payment.²⁵³ By necessitating a countersigned document, Mid-America or Jenco could have reserved the power in one of their corporate officers to be the final barrier against the bad-faith shipment of the unwanted tires.

5. *Arbitration Clauses*

In the wake of the *Mid-America Tire* holding, an attorney wishing to protect his client from either the “fraudulent” seller or the buyer who seeks an injunction from payment in bad faith has several options. As discussed above, the documents a party requires for presentment greatly protects the parties from deceitful and fraudulent activities.²⁵⁴ Another alternative is using an arbitration clause in the contract.²⁵⁵ Arbitration offers a greater opportunity for relief for a wronged party than even the UCC can provide.²⁵⁶ Arbitration awards can include both compensatory and consequential damages as well as attorney’s fees.²⁵⁷ In the event an unscrupulous party has committed a “willful” or “egregious” fraud, punitive damages can be awarded in an amount up to “twice the compensatory and consequential damages.”²⁵⁸

V. CONCLUSION

The Ohio Supreme Court’s *Mid-America* decision represents a position favoring the protection of an Ohio citizen who the Supreme Court felt was

²⁵² DOLAN, *supra* note 17, at § 5.4.

²⁵³ DOLAN, *supra* note 17, at § 5.4. If the buyer’s refusal to countersign is arbitrary, the seller has the opportunity to receive a court order mandating the buyer or his agent countersign the document. DOLAN, *supra* note 17, at § 5.4. However, this is not a quick and easy process and there is the possibility that the letter of credit will expire before the order is obtained. DOLAN, *supra* note 17, at § 5.4.

²⁵⁴ See *supra* text accompanying notes 233-254.

²⁵⁵ See generally Blodgett & Mayer, *supra* note 1, at 443, for a detailed discussion of the benefits of arbitration in letters of credit.

²⁵⁶ Blodgett & Mayer, *supra* note 1, at 447.

²⁵⁷ Blodgett & Mayer, *supra* note 1, at 447.

²⁵⁸ Blodgett & Mayer, *supra* note 1, at 465-66.

defrauded.²⁵⁹ The decision, however, has the potential to significantly weaken and all but eliminate the purity of the independence principle in letters of credit and confuse the jurisprudence of the fraud exception. Moreover, the intentions of the parties to a multinational letter of credit, in desiring to contract outside of the Uniform Commercial Code, should not be rendered meaningless.

The commercial viability of the letter of credit is at risk.²⁶⁰ Undoubtedly, lower courts will feel entitled to grant injunctions on the payment of letters of credit with less hesitation and discipline. With the frequency of injunctions based upon underlying transactional disputes increasing, the impediment of the letter of credit as a cornerstone of international transactions involving the sale of goods and services becomes assured.

ROCCO D'ASCENZO

²⁵⁹ Mid-America Tire, Inc. v. PTZ Trading Ltd., 768 N.E.2d 619, 644 (Ohio 2002), *reconsideration denied by* 772 N.E.2d 126 (Ohio 2002).

²⁶⁰ See Blodgett & Mayer, *supra* note 1, at 467.